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MULTINATIONAL CORPORATIONS

VOLUME 2

MULTINATIONAL TAX

IAN F.G. BAXTER

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IAN F.G. BAXTER

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Multinational Corporations Seminar

Notes reference Multinational Taxation

Introduction

The purpose of the tax section of the Seminar on Multinational Corporations is to introduce students, generally, to a consideration of tax problems and strategies that may be relevant if a corporation in country X conducts operations in other countries through business entities or establishments in these countries. This approach to taxation is sometimes labelled conveniently "multinational taxation". By definition the topic involves consideration of the tax laws of more than one country and the basic elements are: (i) comparative study of national systems of taxation affecting international business operations (e.g. income taxation of business entities); (ii) bilateral tax agreements between countries (which provide some relief from "double taxation" of the same income by different countries). Nowadays most such agreements are based on a model agreement prepared by the Organization for Economic Co-operation and Development (O.E.C.D.). Multinational taxation is an important factor in determining the profitability of the business operations of multinationals, and charges on repatriation of profits. There are substantial differences between the rules and rates of relevant taxes in different countries (e.g. rates of corporation income tax range from zero to over 50%). It is also an important element in tax planning by governments.

The study of "multinational taxation" is, therefore, more general and to be distinguished from a study limited to the Canadian tax rules which affect (i) foreign business operating in Canada, and (ii) taxation of the foreign income of Canadian corporations. The Seminar on Multinationals does not aim to provide a detailed study concentrated on the sections of the Canadian Income Tax Act affecting the taxation of foreign business in Canada and the foreign income of Canadian corporations. Multinational taxation, instead, looks at revenue laws comparatively from the points of view of multinationals with widely-based business operations in many countries, and host governments.

The contents of these Notes are:

(a) Introduction.

(b) Summaries of the main income tax provisions affecting international business operations in the following countries: Canada; France; West Germany; Hong-Kong; Japan; Netherlands; Switzerland; U.K., U.S.A., Venezuela.

(c) Brief comments on comparative indirect taxation, particularly Value Added Taxes in the European Common Market.

In regard to (b), the country-by-country summaries are each arranged with a similar format (to facilitate cross-comparison). This format generally includes:

(1) Taxation of Business Entities This indicates the main income taxes affecting business; business entities (e.g. corporation, partnership, branch) and the kinds of taxes for which they are liable;

the jurisdictional range of corporation taxes (e.g. whether a tax is levied on: world-wide income, only on national source income, on income connected with business, operations, etc.); rates of tax; capital gains taxes.

(2) Taxation of Foreign Investments. This involves consideration of taxation of income received from another country. Such income may already have suffered foreign taxes, e.g. foreign withholding tax, foreign corporation income tax. Foreign income may be only taxable in the foreign source-country (e.g. by virtue of a double-taxation treaty) or it may be taxable in both the source-country and the recipient-country (e.g. if corporation tax of the recipient-country is not limited to national source income). If it is taxable in both, then (by virtue of a double-taxation treaty, or often unilaterally if there is no applicable treaty) there will usually be a measure of relief in the form of a tax credit for certain of the foreign taxes, and the nature of this credit, and limitations on the amount of the credit are mentioned. The credit may be more extensive in the case of a certain degree of association between the foreign-source and domestic-recipient business entities, and this is mentioned.

(3) Taxation of Shareholders

Dividends to shareholders are usually paid out of profits that have already suffered domestic corporation tax, and they are also taxable income of the recipient shareholders. This may be regarded as a type of (domestic) "double-taxation". Many countries grant some relief from this, e.g. in the form of crediting back to the shareholder some of the corporation tax related to the dividend. But the policies

and approaches are different in different countries. [Some general comment on this topic, particularly related to "harmonization" of tax laws in the European Common Market, is made later in this Introduction].

(4) Foreign Undistributed Income

A domestic corporation establishes a foreign-base company in a foreign country which is a "tax haven" (having low corporation tax or none at all). The foreign base company is merely a low-tax collecting point for revenue from activities such as: asset holding, leasing, provision of management services, processing bank loans and insurance business. The foreign-base company does not repatriate the income received but accumulates it (and perhaps lends it to other units of the multinational). Some western countries consider that such foreign undistributed income should not escape domestic taxation and they have anti-avoidance legislation with this in view.

(6) Tax Incentives

Many countries have special tax incentives as part of their economic policy. Some of these are indicated in the Notes.

Students in the Seminar on Multinationals are required to attend class sessions and to write a research paper. So while students A and B both attend the 3 or 4 two-hour class sessions on multinational tax, student A may be doing a research paper on multinational tax but student B may be doing a research paper on some other area of the Seminar (e.g. the relation of multinationals and host and parent countries). The purpose of the Notes is to provide background reading

material for both students A and B, and also the Notes are more detailed than might otherwise be required for this purpose, in order to give A some general "start-up" material to assist in thinking about the research paper.

Obviously, the country-by-country summaries are substantially limited both as to completeness of coverage and detail. Some important topics for the tax practitioner have been omitted because they could not be properly treated without overloading this Note with masses of detail. An example is the question of property in respect of which certain deductions are allowed against taxable income because the property depreciates in value with time. Different countries have different approaches to this question, and most have complicated rules, and rates for different types of property. No easy general comparison can be made between one country and another in regard to depreciation allowances without becoming involved in attempted rate comparisons between similar classes of property, and so on. But allowances related to depreciation, and other forms of tax allowances related to assets, are of practical importance in given cases and can involve substantial sums of money.

Another large and complicated subject that it is not possible to deal with in detail in notes such as these, is the general area of transactions between head offices of multinationals and their foreign-situs subsidiaries and branches. This includes what is known as "transfer pricing". Suppose the head-office of multinational X situated in country A provides management services to its subsidiary

in country B, charging a price P for the service. An increase in P will increase the taxable income of the head-office and decrease the taxable income of the subsidiary (by increasing its costs) and a decrease in P will have the reverse effect. If the business taxes levied in A differ substantially from those in B, variations in P could change the total tax burden of the parent and subsidiary. Applying this to a large multinational with operations in many parts of the world, there would be significant possibilities for reducing the total (world) taxes paid by the multinational. Tax is not the only consideration involved in transfer pricing, but it is an important one.

Most governments are under pressure to collect as much tax revenue as possible to help to meet their heavy expenditures and to reduce borrowing. So many governments now adopt a tougher attitude than in the past to prevent loss of revenue by the adjustment of transfer prices. The main weapon against international tax avoidance by transfer pricing is the principle of "arm's length bargaining" i.e. prices charged between associated enterprises should not differ from those which would have been negotiated between fully independent enterprises. The principle appears, directly or indirectly, in many national laws and in double-taxation treaties. For example, article 9 of the OECD Model Convention reads:

"Where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons

participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Although the concept of an "arm's length" price may seem to be a neat formula in theory, it presents difficulties in practice because normal open market conditions often do not exist. Among the methods used to apply the formula are: (i) prices charged to foreign customers are compared with prices charged to domestic customers; (ii) prices charged to foreign customers are compared with prices charged by other enterprises; (iii) production costs plus a net profit margin; (iv) sales minus a net profit margin; (v) average gross profit of the type of business applied to production cost.

It can be a difficult task for a multinational with operations in many countries to adjust its pricing strategies to correspond with many different national interpretations and applications of arm's length transactions. In 1976, in the European Common Market, a proposed directive was submitted to the EEC Council for arbitration procedure which would apply to transfer pricing disputes. The proposal was that if "the tax administrations of the countries

involved in a price adjustment procedure cannot agree on an arm's length price to be used in the pertinent case, the matter in dispute would be referred to an arbitration commission which will make a decision which is binding as to all parties, thus definitively preventing economic double taxation": (van Waardenburg, Transfer Pricing Arbitration Procedure, 18 European Taxation, 144-151 at 146; the text of the proposed directive is reproduced at pp. 149-151). Unfortunately the directive has not yet been adopted.

One of the topics mentioned above (under "Taxation of Shareholders") is the question of a companies' profits being subject to corporation tax before payment of a dividend and then the dividend also being subject to tax (as income of the shareholder). Some countries provide relief from this so-called double-taxation of dividends in different ways (e.g. by "imputing" or crediting the shareholder with some of the corporation tax paid by the company that distributes the dividend) and some not at all. Variations in approach to this problem can make significant differences to the total amount of income received from the company (i.e. the cash dividend plus any tax credit) and so can increase or decrease the attractiveness of equity investment in a particular country. The following are examples of present-day approaches to this problem and differences in principle.

(a) "Classical" system . Under this system, the revenue authorities collect both corporation tax (at full rate) from the company paying the dividend, and tax from the shareholder on the dividend received. No tax credit is given. In other words, the "double-

taxation" issue is ignored. This was the position in most countries up to a decade or so ago.

(b) "Two-rate" system. This is the system in West Germany. Distributed profits are taxed at a lower rate of corporation tax than undistributed profits. The shareholder then receives a tax credit (in West Germany this is equal to the reduced rate of corporation tax). The amount of the credit is taxable income of the shareholder.

Let C = the reduced rate of corporation tax; T = the effective rate of tax of the shareholder; and S = the sum to be distributed by the company (before deduction of corporation tax). Then the dividend received by the shareholder is S - CS. The taxable income of the shareholder (related to the dividend) equals the dividend received plus the tax credit. Let the tax credit = C (as in West Germany). Then the taxable income related to the dividend = S, and the tax payable by the shareholder is TS - C. Consequently, the total amount of tax obtained by the government from (i) the shareholder and (ii) the shareholder is: (TS - C) + C = TS. This means that the total tax obtained equals tax at the shareholder's effective rate on the sum distributed by the company, and this total is collected partly from the company and partly from the shareholder.

(c) "Advance corporation tax" (A.C.T.) system. This is the system in the United Kingdom. A company issuing a dividend, pays an instalment of corporation tax, i.e. A.C.T. A shareholder receives a tax credit equal to the amount of ACT appropriate to the dividend. The amount of the credit is taxable income of the shareholder.

In current U.K. tax law, this system is set up so that an individual taxpayer with a certain personal income tax rate (called the "basic" rate: which was 33% in 1978/79) pays zero personal income tax on the dividend.

(d) "Avoir fiscal" system. This is the system in France.

A tax credit (called an "avoir fiscal") is given, amounting to half the dividend received. The avoir fiscal is taxable income of the shareholder.

In regard to the taxation of dividends, different imputation systems can be distinguished according to whether or not they ensure that the individual shareholder does not claim a dividend credit or abatement in respect of dividends from a domestic corporation paid out of income which has not borne the appropriate rate of corporate tax. Of the industrialized countries, the Canadian and Italian systems involve an "automatic" dividend tax credit unrelated to the corporate income tax.

[For an algebraic comparison of the effects of different approaches to dividend taxation see "The Structure and Reform of Direct Taxation" (1978): the "Meade Report", pp. 265-268].

The creation of a Common Market was the object of the Treaty of Rome (1958) which established the European Economic Community (E.E.C.). The tax provisions of the treaty relate to the basic aims of the E.E.C., namely, free movement of goods, persons, services, and capital. So far as taxation is relevant to these aims, it is the concern of the Community to "harmonize" the tax laws of the constitute countries.

Certain articles of the Treaty of Rome apply to taxation. Article 95 prevents higher duties being levied on goods imported from other EEC countries than are correspondingly levied on domestic goods, and articles 95

and 96 together are intended to prevent revenue discrimination against imported goods in favour of domestic goods. Generally (in articles 95-99) the purpose is to harmonize national legislation on turnover taxes, excise duties, and other forms of indirect taxation. One result has been the introduction of a value-added tax (V.A.T.) based on the same general principles throughout the EEC. [See the discussion of this type of tax in the last part of these Notes].

The Commission of the EEC has also considered the question of harmonization of systems of company taxation and of withholding tax on dividends. [Details and discussion of the Commission's proposals are given in 16 European Taxation, nos. 2-4 and 18 European Taxation, pp. 372-383 See also Soldati, Taxing Corporate Income (1976) 24 Amer. J. of Comp. L., 246.

The bases of the Commission's proposals are that (1) each Member State will apply a single rate of corporation tax which must lie between 45% and 55%, and (2) a dividend by a corporation of a Member State will confer a right to a tax credit on a shareholder who is a resident in a Member State. There will be only one rate of tax credit in each Member State which must lie between 45% and 55%. Consequently, the "harmonization" proposal by the EEC Commission for the taxation of dividends resembles (on the average) the "avoir fiscal" system which pertains in France. [See supra this Introduction and the notes on France].

CANADA

[This note on Canada is only intended for general comparison with the notes on other countries. It is not, of course, meant to be a comprehensive statement of business taxation law in Canada.]

(1) Taxation of Business Entities

Canadian income taxes affecting business are: federal and provincial corporation taxes; personal tax.

In a partnership, the individual partners are assessed for income tax on their respective shares of the partnership profits. The partnership per se is not taxed (and is not liable for corporation tax), but the computation of income is usually made at partnership level and the result allocated among the partners. Physical partners pay personal tax and corporate partners pay corporate tax.

A corporation is liable for federal corporation tax if it is a resident of Canada, or if it is carrying on business in Canada, or possibly if it derives income from services rendered in Canada. [For a detailed discussion see e.g. Scace, Income Tax Law of Canada, (4th ed., 1979) ch. 1.]. The main criteria for corporate residence in Canada are: (a) if it was incorporated in Canada after 26th April, 1965; (B) if it was incorporated in Canada prior to 27th April 1965 and carried on business in Canada during any post-1965 taxation year. A corporation that was non-resident before 27th April 1965 will remain so if (i) its management and control remain outside Canada

and (ii) it does not carry on business in Canada. At common law, a corporation is resident where its central control and management are situated. The provinces impose income tax on income allocable to a permanent establishment in the province. (See, e.g., Ontario Corporations Tax Act, ss.2, 7; Quebec Taxation Act, ss. 17-22).

There are also special taxes in certain provinces on the profits of mining and mineral production. (See generally for details, Holland and Kemp, Canadian Taxation of Mining Income, 1978).

Unless otherwise indicated this note deals only with federal corporation tax. The federal Income Tax Act is referred to as I.T.A.

The current rates of corporation tax are:

(a) Basic federal rate, 46%. Federal corporation tax on qualifying profits from Canadian "manufacturing and processing" (defined in Income Tax Regulation 1104(9) is reduced to 40% (and further reduced to 20% if the small business deduction applies).

(b) Deduct provincial tax credit of 10% for income earned in a province (excluding the Yukon).

(c) Certain Canadian-controlled private corporations are entitled to a rate of 25% in the first $150,000 of taxable income (under the small business provisions). (For the meaning of a "controlled private corporation" see I.T.A. ss. 89(1)(f), 257(2)). Bill C-17 proposes a 33% tax on certain personal service and management fee income of certain Canadian-controlled private corporations.

A tax rate may also be affected by an international tax agreement between Canada and another country. (E.g. under the Canada - U.S. tax treaty, the rate of tax on income payable from a Canadian source to a corporation organized under U.S. law, and having no permanent establishment in Canada, is limited to 15%). A new Canada - US tax treaty has been signed but is not yet ratified.

One-half of capital gains are taxable and one-half of capital losses are deductible (but usually only against capital gains). Excess of capital losses over capital gains (in the same tax year) may be carried back one year and forward indefinitely. Canadian tax legislation does not clearly differentiate gains that are taxable 100% as business income and other gains that are only taxable 50% as capital gains and reference has to be made to court decisions. It can be difficult to distinguish between a capital gain (taxable as to one-half) and a gain from a business venture which is taxable as ordinary business income.

In addition to corporation taxes at normal rates, a Canadian branch of a foreign corporation is subject to an additional 25% on after-tax profits (minus any increase or plus any decrease in investment by the branch in Canadian property)(I.T.A. s. 219(1)). But the 25% rate is subject to any applicable international tax agreement. The reduction in the 25% rate for a Canadian branch of a U.S. corporation is an abatement allowed unilaterally by Canada, reducing the branch profits rate to the dividend rate.

(2) Taxation of Foreign Investments

In this section we consider income received in Canada from a source outside Canada. Such income may already have suffered foreign taxes, e.g. foreign withholding tax; foreign corporation tax.

A corporation resident in Canada (or a Canadian branch of a foreign corporation; see previous section) is liable for corporation

tax on taxable income derived from both Canadian and foreign sources, unless an item of foreign source income is exempt from Canadian tax by an international tax agreement. By international tax agreements (e.g. Canada - U.S., Canada - U.K.) a non-resident corporation is only subject to Canadian tax if it carries on business in Canada through a permanent establishment or disposes of taxable Canadian property, and only on income attributable to the Canadian sources.

A "foreign affiliate"* is a non-resident corporation in which the "equity percentage" of a taxpayer resident in Canada (other than a non-resident-owned investment corporation) is at least 10% (I.T.A. s.95(1)(d)). If X owns shares in corporation P., his equity percentage is termed "direct equity percentage" (I.T.A. s. 95(4)(a)). If P owns shares in corporation Q, X has an equity percentage in Q. Let X own 20% of the shares of P and P own 30% of the shares of Q. Then X's equity percentage in Q is 30% X 20% = 6% (I.T.A. s.95(4)(b)).

A corporation resident in Canada that has a foreign affiliate is entitled to (a) certain deductions in respect of dividends received from the affiliate, (b) certain tax deferral ("rollover") privileges on merger, re-organization, or dissolution of the affiliate. A stock dividend from a foreign affiliate is tax exempt (I.T.A. s. 95(7)).

In regard to dividends, a corporation resident in Canada may deduct from taxable income: (i) the amount of any dividend paid out of "exempt surplus" or "pre-acquisition surplus", of a foreign affiliate; (ii) the "underlying foreign income tax" and the foreign

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* Dart, Reorganization of Foreign Affiliates, 25 Can. Tax. J., 151 and 403; Broadhurst, Foreign Affiliate Regulations Revised -- Again, 28 Can. Tax J., 202.

withholding tax in respect of a dividend paid out of the "taxable surplus" of a foreign affiliate. The meaning of "exempt surplus" includes the net earnings of an affiliate from an active business carried on by it in Canada or in a country with which Canada has, or is negotiating a comprehensive income tax treaty (Income Tax Regulation 5907(1)(d), (11)). "Pre-acquisition surplus" refers to any retained earnings or other funds of a corporation (other than exempt or taxable surplus) out of which a dividend is paid. [For details of these definitions see Scace, Income Tax Law of Canada (4th ed., 1979), pp. 659-662]. "Underlying foreign income tax" is defined in Income Tax Regulation 5907(1)(1), and a typical example is foreign corporation tax.

Situations may arise where the same income will be subject to both Canadian and foreign income taxes, and tax credits may be available against Canadian income tax liability to give relief from such double taxation.

There is a tax credit against "business income tax" paid to a foreign government (I.T.A. s. 126(2)). The upper limit of the credit is given by --

$$TB/A$$

where B = foreign business income, A = total taxable income from Canadian and foreign sources, T = Canadian federal and provincial taxes on A.

There is a similar foreign tax credit against "non-business income tax" (e.g. dividends, interest, royalties) paid to a foreign

government (I.T.A. s. 126(1)). The upper limit of the credit is given by --

$$\frac{TN}{A}$$

where N = foreign non-business income.

The credits are calculated separately for each foreign country involved (I.T.A. s. 126(6)).

Unused foreign tax credit in respect of business income may be carried forward for the succeeding five years, but only with reference to business income in the same foreign country. There is no carry back of a business income foreign tax credit, and no carry forward or back of a non-business income foreign tax credit. The non-business income credit only applies in respect of non-business income tax paid to the country in which the income was earned. The business income credit applies to foreign taxes whether or not the income arose in the taxing country.

(3) Taxation of Shareholders

Cash dividends to shareholders are paid out of profits that have usually suffered corporation taxes and they are also taxable income of the recipient shareholders. So there is a form of double taxation.

Under Canadian tax law some relief is given to a shareholder in the form of a dividend credit received by the shareholder which can be set-off against other taxes due by the shareholder

in the same tax year. The average rate of Canadian federal and provincial corporation tax is approximately 50%.

An individual Canadian taxpayer adds a gross-up of 50% to dividends from Canadian corporations and receives a federal tax credit of 25% of the dividend plus gross-up. The federal tax credit is deducted before provincial taxes are applied. The result is a tax credit approximately equal to the gross-up. [The Canadian dividend credit can be compared with the French avoir fiscal system, which it resembles in principle, (see notes on France, section (3)).].

(4) Foreign Undistributed Income

If a foreign affiliate of a taxpayer is also a "controlled foreign affiliate", the taxpayer is liable for Canadian tax on the share of any "foreign accrual property income" (F.A.P.I.) relative to the taxpayer's participating percentage of shareholding in the affiliate. This Canadian tax liability arises whether or not the relevant income is repatriated to Canada.

A "controlled foreign affiliate" is a foreign affiliate that is controlled directly by the taxpayer or indirectly by him and not more than four other persons resident in Canada, or by a related group of persons, wherever resident, of which he is a member. Control means the power to elect a majority of directors at a general meeting. (I.T.A. ss. 95, 186(2)).

Generally (but with some exclusions) F.A.P.I. consists of income, including taxable gains, from sources other than active business. (I.T.A. s. 95).

But, for example, by the F.A.P.I. rules, interest charged by a tax haven subsidiary of a Canadian corporation to a U.S. affiliate of the same Canadian corporation, in respect of funds used by the U.S. affiliate in an active business in the U.S., does not constitute F.A.P.I. income to the tax haven affiliate. So Canadian taxpayers can use tax haven subsidiaries.

The controlled foreign affiliate provisions are anti-tax-avoidance in objective. A Canadian taxpayer might see advantages in establishing a foreign base company as a subsidiary in a "tax haven" country which has low corporation tax (or none at all). The foreign base company is not intended to conduct active business in the tax haven, but to be a collecting point for revenue from activities such as: asset holding; leasing of movables; granting the use of patents and know-how; provision of management and other services; processing bank lending or insurance business. The subsidiary need not distribute the income received, but could accumulate it in the tax haven, or lend it to the parent company or to another subsidiary.

(5) Corporate Groups and Reorganizations

Consolidated group tax returns are not permitted in Canada. There are various special provisions in Canadian tax law for tax deferral (on a "roll-over" basis) in regard to: transfer of

property to a corporation (I.T.A. s. 85); reorganization of capital (I.T.A. s. 86); amalgamation (I.T.A. s. 87). These are too complex to be discussed in this note. Reference can be made to texts on Canadian income tax for details.

(6) Tax Incentives

There are a variety of federal and provincial programmes, e.g. for regional development, which include tax incentives. There are also tax incentives for investment, research, and other objectives.

FRANCE

"France" includes Corsica and the overseas departments of Guadeloupe, Guyane, Martinique, and Réunion.

The main French direct taxes affecting business are: Corporation tax (impôt sur les sociétés) and personal tax (impôt sur le revenu).

The profits of a partnership (société de personnes) are taxed in the personal names of each of the partners. The profits are allocated among the partners corresponding to their respective shares, and this includes all taxable profits whether distributed or undistributed. Although a French partnership has legal personality, the taxes are not assessed on the entity but on the partners. This principle is called fiscal transparency (transparence fiscale).

But a partnership may elect to pay corporation tax instead of having the partners taxed individually on the share of profits. Fiscal transparency applies to a group of companies operating like a partnership e.g. under the G.I.E. legislation (Groupement d'intérêt économique: Ordinance 67-821, 23 Sept. 1967, art. 19).

Corporation tax is payable principally by companies with a share capital (e.g. société anonyme, S.A.; société à responsabilité limitée, S.A.R.L.; société en commandite par actions, S.C.A.). The current rate of corporation tax is 50%.

Unlike many other countries, French corporation tax is territorial in its application, and it is imposed on the taxable profits of business undertakings carried on in France and on the profits of business undertakings that are taxable in France under double taxation treaties.

Suppose a French company with its head office in Paris has a wholly-owned U.S. subsidiary doing business in New York State. The American profits earned by the subsidiary are not subject to French corporation tax (by reason of the territoriality principle). Law No. 76-660 of 19th July, 1976 introduced a general capital gains tax (imposition généralisée des plus-values). In general the legislation applies to individuals, chiefly in relation to gains on real property and on the disposal of personal property. The application of the Law to securities was postponed until 1st January 1979. The French revenue authorities gave a ruling in 1978 that capital gains on securities of a company which predominantly holds real property are taxed like capital gains on real property. Long-term capital gains of a corporation (generally on fixed assets held for at least 2 years) are taxed at 15% and the after-tax gain is credited to a special reserve. If a dividend is paid from the reserve, the difference between 15% and the 50% corporation tax is payable. Short-term capital gains are taxed at 50%.

The Law makes a foreign entity, i.e. an entity which does not have its seat (siège social) in France, subject in principle to capital gains tax at less than the 50% corporation tax rate, unless the gain can be attributed to a French permanent establishment of the entity (in which case they would be subject to French corporation tax at 50%). The rate of 33 1/3% applies to gains from realty situated in France. Gains from the disposal of French shares which constitute a "substantial interest" (usually a participation exceeding 25% of the company's capital) are taxed at 15%. So (subject to any double-taxation treaty that may be applicable) foreign corporations may be liable for capital gains tax on the sale of French realty or substantial interest shareholdings: (Reference: van Waardenburg, 17 European Taxation, 226-245).

Due to the territoriality of French corporation tax, foreign source profits earned by a foreign branch of a French company are not subject to French corporation tax. Conversely losses of such a branch are not deductible by the French company for purposes of French corporation tax.

A permanent establishment in France of a foreign business entity (such as a branch) is liable for French corporation tax.

There are some exceptions to the territoriality principle, mainly to encourage foreign operations by French companies (which will be mentioned later in the section of this note on tax incentives).

Another breach in the territorial principle was introduced in the Finance Bill of January 1980. Generally the proposal was for a new tax affecting holding company subsidiaries or subsidiaries carrying on activities within a group of companies or are foreign sales or services companies. The new provisions have some analogy to the Subpart F legislation in the U.S. and the West German legislation on foreign base companies.

(2) Withholding Taxes

In certain cases payments from French sources to non-residents are subject to French withholding tax (retenue à la source) which must be transmitted by the payer to the French revenue authorities, and may be deducted from the payment. For example, French withholding tax applies to: dividends (25%); royalties from patents, trademarks, licences, know-how, and the like (generally 24% of 80% of the royalty = 19.2%); interest on bonds, debentures, debts represented by negotiable instruments (25%, and 33 1/3% if not represented by negotiable instruments); repatriated branch profits (25%).

As mentioned at the end of section (1) above, the repatriated profits of the French branch will also have suffered corporation tax at 50% calculated on the branch profits before deduction of the withholding tax. So if the pre-tax branch profit is 100, the French taxes are:

Corporation tax at 50%	50
Withholding tax at 25% on the pre-tax profits minus the corporation tax i.e. 25% of 50	12.5
	62.5

In the case of a French subsidiary a distribution to the foreign parent would be in the form of a dividend and subject to the dividend withholding tax rate [taxation of shareholders is discussed in section (3) of these notes].

The foregoing rates of withholding tax may be reduced by tax treaties.

(3) Taxation of Shareholders

Cash dividends are taxable under the French system, but not dividends distributed in the form of stock.

Dividends paid to French residents are not subject to French withholding tax.

Shareholders resident in France (whether corporate or individual) are entitled to a tax credit in respect of dividends received by them from French companies (with certain exceptions e.g. some investment companies and agricultural co-operatives). This credit is called an avoir fiscal, and amounts to 50% of the dividend received. The avoir fiscal is taxable income of the shareholder. An avoir fiscal is also available to some non-resident shareholders under tax treaties between France and certain other EEC countries.

Consider the case of a French corporation A paying a dividend of 100 to a French resident shareholder B. Suppose B has an effective tax rate of 40%.

The avoir fiscal is 50 and so B receives in all 150 of taxable income namely, 100 from A and 50 as a tax credit from the revenue authorities. Consequently B's tax liability in relation to the dividend is: --

Tax on 150 at 40%	60
Less Avoir fiscal	50
Tax payable	10

The avoir fiscal is 1/3 of the total taxable income related to the amount of dividend received by the taxpayer (from the company and the revenue authorities).

Under the avoir fiscal system the recipient of cash dividends is endowed with an imputed tax credit which equals one-half of the corporation tax which would be paid by a French company liable for corporation tax at 50%. It is, therefore, a method of partially alleviating the so-called double-taxation effect which occurs when a taxpayer pays tax on a dividend from a company out of profits on which 50% corporation tax has already been paid. [Compare with the two-rate system discussed in the notes on West Germany and the system of "advance corporation tax" discussed in the notes on the United Kingdom].

A parent company (société mère) for tax purposes is a French company that holds at least 10% of the issued share capital of a French or foreign subsidiary (société filiale) where the shares held are either (a) registered or (b) are bearer shares deposited with an financial establishment approved by the Administration. When a dividend is received by a parent from its subsidiary, the taxable income is 5% of the dividend received plus any tax credit available by French law or under a tax treaty between France and another country. The 5% is an arbitrary figure supposed to represent the expenses of the parent in relation to the dividend. The purpose of this tax concession is to alleviate the so-called double taxation which would result if a transfer of revenue between two affiliated companies were taxed in the hands of both parent and subsidiary.

The avoir fiscal system rests on the assumption that dividends are paid from profits that have been taxed at 50%. But this may not always be the case. In order not to complicate the effect of the avoir fiscal system on shareholders, companies whose distributions qualify for avoir fiscal are required to withhold tax from the distribution to balance the amount of the avoir fiscal on dividends out of surplus taxed at 50%. This balancing tax is called the précompte mobilier.

The effect of the précompte can be shown by an example.

Company A pays a dividend to shareholder B out of funds on which no French corporation tax has been paid. B has an effective tax rate of 40%. The amount of the dividend before deduction of

précompte is 100. Let the amount of the précompte be X.

Then the dividend received by B is (100-X). The avoir fiscal is 50% of the dividend received and the précompte equals the avoir fiscal. Therefore:

X = 1/2(100-X) so that X = 33 1/3.

Consequently B's tax liability in respect of the dividend is:

Tax on 100 at 40%	40	
Less Avoir fiscal	33 1/3	
Payable by B		6 2/3
Précompte: deducted by A		33 1/3
Total tax		40

The précompte is deducted by companies whose distributions qualify for avoir fiscal from the following dividend distributions:

(a) Profits which have not borne 50% French corporation tax. An example is a dividend distribution out of foreign source income.

(b) Profits earned 5 years before the distribution (whether or not they have borne French corporation tax).

If a French parent receives a dividend from a subsidiary, the parent does not pay 50% corporation tax. [See above reference "parent" and "subsidiary" for tax purposes]. So if the parent redistributes any of this dividend income it must deduct précompte. If the parent received the dividend from a foreign subsidiary, foreign withholding tax may have been deducted. If so the amount of the foreign withholding tax can be credited against the précompte.

A French branch of a foreign company is not subject to precompte (because a foreign company does not qualify for avoir fiscal).

A comparison of the general tax position of different French business entities receiving dividends can be indicated as follows on a declared dividend of 100 in each case:

	French "Parent" (Société Mère)	French Company (Not a parent)
Withholding tax	Nil	Nil
Dividend received by shareholder	100	100
Avoir fiscal	50	50
Amount subject to tax	7.5[1]	100
Corporation tax at 50%	3.75	50
Deduct half tax credit	Nil	25[2]
Tax payable	3.75	25
Declared dividend less tax	96.25	75

(1) The taxable amount is 5% of (dividend + credit) i.e. 5% of (100 + 50) = 7.5

(2) The corporation tax on the dividend plus the avoir fiscal is 50% of (100 + 50) = 75. The tax payable is, therefore, this amount less the avoir fiscal i.e. 75 - 50 = 25. This is the same as the corporation tax on declared dividend less one half of the avoir fiscal ie. (50 - 25) = 25.

(4) Corporate Groups and Reorganizations

There are three systems of group taxation, each of which requires the approval of the Ministry of the Economy and Finance. (Reference: Oliveau, 18 European Taxation, pp. 231-236). These are:

(A) Although (as mentioned on p. 1 of these notes) French corporation tax is territorial in its application, a French company may be authorized by the Ministry to be taxed on the group results of its activities both in France and outside France, through any permanent establishment except a subsidiary. This authorization is called bénéfice mondial.

A French company may be authorized to make a tax return consolidating the income from permanent establishments, including subsidiaries (and second-tier subsidiaries), which it controls, both inside and outside France. This authorization is called bénéfice consolidé. Control means at least 50% of voting rights directly or indirectly.

(B) A French company may be authorized to make a tax return consolidating the income of itself and any other French companies of which it owns at least 95% of the share capital.

[See supra reference the relationship of parent company (société mère) and subsidiary (société filiale) for tax purposes.]

If group returns are permitted it means that profits of one company can be set off against losses of another company of the group. The principle of territoriality prevents the set-off of foreign branch losses against the taxable income of the French company, but an authorization under (A) above would permit this. So a group authorization might assist a company setting up a foreign operation and expecting to incur some losses during the initial years.

A reorganization may involve a merger of companies (fusion de sociétés), which can take various forms e.g. the absorption of one company by another company; the creation of a new company out of two old companies. Another form of reorganization is the division of an existing company into two new companies (scission de sociétés). (Reference: Halpern, Taxes in France (2d. ed., 1976) pp. 189-199).

The tax consequences of reorganization is a complex subject, and only the general policy and effects of the legislation are indicated in this note.

If the shareholders of the old company receive shares in the new company in exchange for their shares in the old company, this is not regarded as taxable income. If the new company assumes any tax liability of the old company, the merger will be tax neutral and the old company will not be liable for tax on gains arising from the merger.

The new company may be liable for capital gains tax if it records a transferred depreciable asset at a greater book value than it stood in the books of the old company, but the tax may be spread over a number of years. If the asset is not depreciable, there will be no immediate capital gains tax, but there may be capital gains tax if the asset is later sold by the new company. The gain is the excess of the sale consideration over the value in the books of the old company when the asset was transferred.

(5) Tax Incentives

Since 1958 French tax incentives have been introduced for the development of research and technology. (Reference: Sibille, 18 European Taxation, pp. 76-93).

The incentives include: special depreciation allowances on realty applied for scientific research and declining balance depreciation for material and equipment used for scientific research; favourable capital gains treatment for participation in government approved research entities. The policy seems to be to encourage the private sector conduct of research.

Federal Republic of Germany

[For convenience hereafter referred to as "Germany"].

(1) Taxation of Business Entities

The German income taxes affecting business are: Corporation tax (Körperschaftsteuer); Personal tax (Einkommensteuer).

Partnerships are subject to municipal trade income tax (Gewerbesteuer) and the physical partners pay personal tax. Corporate partners pay corporation tax.

Companies which have their management control or seat of business in Germany are liable for German corporation tax on world income unless there is a double-taxation treaty in existence which modifies this rule.

Company X manufactures widgets in a factory in Spain, but its management control is in Germany. X is liable for German corporation tax on its profits from the manufacture of widgets.

Companies which do not have their management control in Germany pay corporation tax on profits attributable to the operation of any permanent establishment in Germany. This rule may also be affected by a double-taxation treaty.

The German sector of the continental shelf is regarded as part of Germany with respect to the exploitation of minerals.

The German-Canadian income tax agreement, 1976, has not been ratified by the respective governments and the 1967 agreement remains in effect. There are discussions on a new tax agreement.

The Canada-German Tax Agreement defines "permanent establishment in Germany" as a fixed place of business in which the business of the enterprise is wholly or partly carried on. The term includes: a place of management; a branch; an office; a factory; a workshop; a mine or quarry; a building site or construction or assembly project which exists for more than 12 months.

Apart from Berlin source income, the current rates of corporation tax are:

(a) 56% on the undistributed taxable profits of companies with management control in Germany.

(b) 36% on the distributed taxable profits of companies with management control in Germany.

(c) 50% on the taxable income of branches situated in Germany of foreign companies.

(d) 56% on other income of foreign companies (unless subject to withholding tax).

Also significant trade and local income taxes may apply.

A "foreign" company means a company that does not have its management control in Germany.

There are special rates for the encouragement of business in West Berlin, and these are mentioned later under "Tax Incentives".

Capital gains by companies are treated as ordinary income, and so are 100% subject to corporation tax. In certain circumstances, proceeds of a sale of fixed assets by a company may be set against acquisitions to produce a deferral of tax.

An individual is required to include in his personal income tax 50% of a capital gain from the bulk sale of: a sole business; a partnership share; a shareholding of more than 25% in a company.

Generally, capital gains and losses are not included in the taxable income of physical persons.

(2) Taxation of Foreign Investments

In this section we consider income received in Germany from a source outside Germany.

For example: multinational X has a holding company H in Germany for its European operations, and it has a manufacturing company M in country A. H receives a dividend from M equivalent to $85,000. Before repatriating this dividend to Germany, M has paid the following taxes in A:

Withholding tax at 15%	$15,000
Corporation tax at 50%	100,000

(Thus an original amount equivalent to $200,000 was needed to pay the dividend of $85,000 and the taxes in A).

A German corporation is liable for corporation tax on income derived from both German and foreign sources, unless an item of foreign source income is exempt from German tax by a double-taxation treaty. For example, the Canada-Germany Income Tax Agreement, 1976 provides inter alia that business profits of an enterprise of one state are taxable only in that state unless the enterprise has a permanent business establishment in the other state; that profits

from the international operation of ships or aircraft are taxable only in the state where the effective management of the enterprise is situated.

Profits and losses of a foreign branch and dividends from a foreign company in which there is at least a 25% shareholding are excluded from the tax base for municipal trade income tax purposes.

Most German double-taxation treaties exclude the profits of a foreign branch from domestic corporation tax. If there is no treaty, the pre-tax profits and losses of a foreign branch are included in the assessment of German corporation tax.

Generally the profits of a foreign subsidiary are taxed in Germany when repatriated in the form of a dividend distribution. Gains from the sale of shares in a foreign subsidiary are taxed 100%, unless there is a tax incentive concession. Tax incentives are discussed later.

Dividends received from a holding of at least 25% of the voting shares of a foreign company are usually exempted by tax treaties from German corporation tax, and a credit is also granted under German tax law (Schachtelprivileg).

Double-taxation treaties provide for tax credits in respect of certain foreign taxes up to the amount of the German corporation tax attributable to the same amount of income. (See e.g. Canada-Germany Income Tax Agreement (1976), Article 23). German tax law also provides certain unilateral reliefs from direct international double taxation of income and certain capital gains. (Reference: Kuiper,

(1975) 15 European Taxation, 368). The credit is given in respect of income that is considered "foreign" by German tax law.

Foreign tax credits are available to a taxable business entity (such as a corporation) if its seat or place of management is in Germany, for foreign taxes that are the equivalent of German income taxes. So a non-resident corporation (which is subject to German tax only on its German source income) does not qualify for the credit, and neither does a German branch of such a corporation.

Taxes paid in foreign currency are converted to DM as at the date-of-payment exchange rate. There is no carry over of unused foreign tax credit to later years.

As mentioned above, the credit is limited to that part of the German income tax which is attributable to the foreign income, and this formula is applied separately for each country involved. The maximum German foreign tax credit in the case of a corporation is equal to:

Foreign income multiplied by the effective rate of German tax attributable to the total taxable income (including foreign income) from that foreign country.

A resident taxpayer may deduct from income for German tax purposes, foreign taxes paid which are not the equivalent of German income taxes and which were imposed on income taxable in Germany. But the taxpayer must take the credit if it is applicable and cannot choose between the credit and a deduction from taxable income.

(3) Taxation of Shareholders

Dividends to shareholders are paid out of profits that have usually suffered corporation tax and are also taxable income of the recipient shareholders. So there is a so-called double taxation new method of alleviating this was introduced in Germany from January 1, 1977. It is called an "imputation" system because part of the tax paid by the corporation is credited or imputed to the shareholder, thus reducing the amount of personal income tax which the shareholder would otherwise have to pay. As already mentioned, the corporation tax on distributions is at the lower rate of 36% whereas undistributed profits are taxed at 56%. [Compare this system with the system in the U.K. of Advance Corporation Tax (at the "basic rate" of income tax) which is imputed to the dividend recipient. See the notes on the U.K.].

In certain circumstances, if prescribed procedures are followed, a stock dividend may be free of German tax. This can be so if the stock dividend is created by converting into share capital, earned surplus reserves, which have been taxed (at the rate for undistributed surplus) in previous years, and capital surplus reserves. The sale of company shares to employees may be tax exempt.

The distribution rate of 36% is paid whether the shareholder is resident or non-resident. But if the shareholder is non-resident there is also a withholding tax retained by the company and paid to the German revenue authorities. The rate of withholding tax is 25% unless reduced by a double-taxation treaty. (The Canada-Germany

Income Tax Agreement, 1976, art. 10(2) provides a rate of 15%).

Double-taxation treaties normally provide that, apart from withholding tax, a dividend paid by a company resident in State A to a shareholder in State B will be taxed in State B. (See e.g. O.E.C.D. model treaty, art. 10; Canada-Germany Income Tax Agreement, 1976, art. 10). Consider the case of a Canadian resident shareholder (not having a permanent establishment in Germany) who receives a dividend from a German company. Let the pre-tax amount of the dividend be 100. The cash amount received by the Canadian shareholder will be as follows:

Pre-tax		100
German corporation tax at 36%	36	
Withholding tax at 15% on 64	9.6	45.6
		54.4

The 54.4 is included in the Canadian taxable income of the shareholder (and there will likely be a Canadian foreign tax credit available).

A German withholding tax of 25% (Kapitalertragsteuer) must be retained and paid to the revenue authorities on dividends (including taxable stock dividends), and on certain other forms of "capital income" listed in the tax law (Einkommensteuergesetz, s. 43). This withholding tax applies whether or not the shareholder is resident in Germany. If a double-taxation treaty rate below 25% applies to a non-resident shareholder, that shareholder must apply to the German revenue authorities for the reduction. In the foregoing example with the Canadian shareholder, application would be made to reduce the rate from 25% to 15%.

Resident (but not non-resident) shareholders are entitled to an "imputation" 36% tax credit. The taxable income of a resident shareholder includes: (a) the net amount of dividend actually received, plus (b) the withholding tax, plus (c) the corporation tax related to the dividend. To illustrate the effect of the imputation tax credit consider a dividend to a shareholder resident in Germany from a pre-tax amount of 100. Then we have:

Pre-tax amount		100
Corporation tax at 36%	36	
Withholding tax, being 25% of (100-36)	16	52
Net amount actually received		48

The amount included in the taxable income of the shareholder is: (48 + 16 + 36) = 100.

Suppose the shareholder is an individual with a 40% effective rate of personal income tax. Then the shareholder's tax position is as follows:

Tax on 100 at 40%	40
Imputation credit	36
	4

But 16 has already been paid by the shareholder (by deduction at the source as withholding tax) and so the shareholder is entitled to a refund of (16-4) = 12. So the shareholder receives 48 from the company and a tax refund of 12, i.e. a total of 60 = (100 - 40).

Suppose, however, that the shareholder is a corporation resident in Germany. Then the shareholder's rate of corporation tax is 56% (for undistributed income).

The corporate shareholder's tax position is:

Tax on 100 at 56%	56
Imputation credit	36
	20

But 16 has already been paid by the corporate shareholder (as withholding tax) and so the corporate shareholder is due (20 - 16) = 4. So the corporate shareholder receives 48 from the paying company and pays a further 4 in tax, i.e. a resultant of 44 = (100 - 56).

A distribution by a German corporation may be reinvested immediately in the distributing corporation so as to obtain the 36% rate of tax (subject to a capital investment tax of 1%).

If a German company receives dividends from a foreign company resident in a country with which Germany has a tax treaty, there will usually be no German corporation tax payable on this foreign source income. (Compare the Canada - Germany Tax Agreement, Art. 9). But now suppose that the German corporation distributes this same income as dividends, and 100 of this distribution is paid to A (a German resident) and 100 to B (a foreign resident).

In the case of A, the German corporation will pay the 36% distribution imputation tax and deduct at the source and pay to the revenue authorities the 25% withholding tax. So A's position is the same as if his dividend had been paid out of the domestic income of a German corporation (see previous example). B however is not liable for the 36% tax, but is liable for the withholding tax at the applicable treaty rate, or at 25% if there is no treaty. So he obtains a credit for the difference between the 36% tax and the

withholding tax. (Compare the Canada - Germany Tax Agreement, art. 9, s. 3). B, of course, may also be liable for non-German tax on the dividend e.g. for tax in his country of residence.

(4) Foreign Undistributed Income

The case of the foreign affiliate has been mentioned above, namely, the exemption from German corporation tax if the German shareholder holds at least 25% of the voting shares of the foreign company paying the dividend. This provides certain relief from what is regarded as a form of double-taxation, where the shareholder has a substantial ownership in a foreign company, and it tends to produce an equality of overall tax burden between foreign and domestic investment.

But Germany is comparatively a high tax country and so German company X might see advantages in establishing a foreign subsidiary having its seat in a tax haven (e.g. in the Bahamas or in Bermuda, neither of which have any corporation tax). This subsidiary, usually called a foreign base company, is not intended to conduct active business in the tax haven, but to be a low tax (or non-tax) collecting point for revenue from activities such as: asset holding; renting and leasing of movables; granting the use of patents and know-how; provision of management and other services; processing bank lending or insurance business through the foreign subsidiary. The subsidiary does not distribute the revenue when received, but accumulates it in the tax haven, with a view to postponing liability to German tax until any eventual repatriation of the revenue. The foreign subsidiary may also make

loans to the German parent, intending that the parent will be able to deduct the loan interest as a business expense.

The revenue authorities of various countries have moved with legislation to discourage such manoeuvres, and such legislation tends to be complex. The gist of the German legislation is that if more than 50% of the capital of a foreign base company in a "tax haven" is held (directly or indirectly) by German residents, that company cannot insulate its income and assets from German tax. So the German owners are subject directly to German tax and the foreign corporate structure is ignored for German tax purposes. A "tax haven" in this connection means a country have corporation tax at a rate less than 30%. (References: Jehle, The Foreign Base Company in West German Law, a 3 part article beginning at 17 European Taxation 364; Aussensteuergesetz, s. 7.)

(5) Corporate Groups and Reorganizations

If a German company is a controlled subsidiary (Organgesellschaft) of another resident company (Organtragergesellschaft) a consolidated tax return is permitted so that losses of one can be absorbed pro tanto by income of another. For this to apply the parent must own more than 50% of the subsidiary; the subsidiary must be economically integrated with the parent and must operate like a division of the parent; and the subsidiary must be so subject to parental control as to have no will of its own; there must be a written agreement that the parent assumes the profits and losses of the subsidiary for at least 5 years.

New German legislation which came into effect in 1977 (Umwandlungs-Steuergesetz) provides relief or deferral on a roll-over basis in cases such as: a merger or reorganization of corporations; conversion of a sole trader, a partnership, or a division of a business entity into a company. The provisions are too complex to treat in detail in these notes, but generally the main requirements are the transfer of assets at book values for tax purposes and in exchange for shares of the transferee. A transfer at higher than book value attracts tax on the difference. In the case of a non-resident the fair market value applies instead of the book value.

A foreign buyer wishing to take over a German business may do so by buying shares or buying the assets. A sale of shares may make the vendor liable for capital gains tax. In a sale of assets the vendor may be liable for capital gains tax on the excess of the sale price over the book value for tax purposes.

(6) Tax Incentives

The following are 3 of the main sets of tax incentives: --

(a) There are various tax incentives intended to strengthen the economy of West Berlin (Berlin-Forderungsgesetz). These include: a reduced rate of corporation tax on Berlin source income; a reduced rate of tax on dividends from German sources outside West Berlin received by a West Berlin corporation or branch; special depreciation allowances.

(b) Certain investments in developing countries qualify for the transfer of the whole or part of the investment cost to a tax free reserve for 6 years (or 12 years in some cases). Thereafter the reserve must be brought back by instalments into taxable income.

(c) Suppose a German company transfers assets to be invested in a foreign country. If the fair market value exceeds the book value, that difference may (in cases which qualify under a 1969 Law) be transferred to a tax free reserve for five years, and thereafter be brought back by instalments into taxable income.

The purpose of (b) is to encourage investment in developing countries and the purpose of (c) is to encourage foreign investment generally.

HONG KONG

(1) Taxation of Business Entities

Hong Kong imposes a Profits Tax on profits arising from the carrying on of a trade, profession or business in Hong Kong. So individuals, partnerships, corporations, unincorporated business ventures carrying on a trade, profession or business in Hong Kong are subject to profits tax on Hong Kong source income. The rate is 17% for corporate entities and 15% for a sole owner, partnership or an unincorporated venture.

There is no capital gains tax, and profits tax is not levied on capital receipts. There has been a good deal of case law on the question of what is or is not a capital receipt as opposed to a revenue receipt. (Reference: Bush, Taxation and Investment Law in Hong Kong, 136).

There is also case law on what determines whether profits are Hong Kong source or not, and the approach seems to be to look to the locality from which the profits are derived, following the statement of Lord Justice Atkin in Smith v. Greenwood [1921] 3 K.B. 583, 593 that "...the question is, where do the operations take place from which the profits in substance arise?"

Its magnificent harbour and other facilities has made Hong Kong a major centre for foreign base operations, e.g. manufacturing, trading, banking and finance, shipping. Hong Kong also has no sales taxes (except for a registration tax on automobiles) and there

are no import duties except on tobacco products, liquor, toilet preparations, medicines, and hydrocarbon oils, and this has turned Hong Kong into an internationally known retail shopping centre.

A number of companies do business both in Hong Kong and outside Hong Kong, and a tax base for Hong Kong profits tax has to be determined by apportioning their world-wide profits. The following is an example of the type of formulae employed:

Ship Owners and Charterers and Airlines

Liability to profits tax depends on carrying on business in Hong Kong as an owner or charterer ie. if such business is controlled, or managed in Hong Kong, or is carried on by a company incorporated there. The Hong Kong taxable profits are equal to:

(Hong Kong revenue X World-wide profits)/World-wide revenue.

A non-resident who carries on a trade, profession or business in Hong Kong, is taxable directly or by an agent (whether or not the agent has received the profits) on all profits arising in or derived from Hong Kong, and the tax can be recovered from assets of the non-resident or the agent.

If a non-resident carries on business with a closely connected resident, and the business is arranged so that Hong Kong taxable profits are less than might reasonably be expected, the business may be deemed to have been carried on in Hong Kong, and the non-resident will then be taxed accordingly.

(2) Taxation of Foreign Investments

Generally, off-shore income is not subject to Hong Kong profits tax, and the tax authorities are concerned essentially with where the income arose. Income clearly derived from a permanent establishment outside Hong Kong is not taxable. Such income may come from foreign branches or subsidiaries. Income derived outside Hong Kong, and not entering Hong Kong, may be used by a Hong Kong company in Hong Kong or outside Hong Kong, without the income becoming subject to Hong Kong profits tax. A number of foreign corporations have established headquarter companies in Hong Kong to control regional operations in South-east Asia and China.

Hong Kong has no double-taxation treaties with other countries but tax liability in a Commonwealth country (excluding the U.K.) can receive a tax credit, against Hong Kong tax on the same income, if the Commonwealth country gives reciprocal treatment. If the taxpayer is a Hong Kong resident, the tax credit is limited to 50% of the Hong Kong effective tax rate, and this effective rate is obtained by dividing the Hong Kong tax that would be payable on the same amount of income by that income. If the taxpayer is a non-resident and the Commonwealth country effective tax rate does not exceed the Hong Kong rate of tax on the same amount of income, the credit is limited to 50% of the Commonwealth country rate of tax. If the taxpayer is a non-resident, and the Commonwealth country effective tax rate exceeds the Hong Kong effective tax rate, the credit equals

the amount by which the Hong Kong effective tax rate exceeds 50% of the Commonwealth country effective tax rate.

(3) Taxation of Dividends and Interest

Dividends received from a company which has paid Hong Kong profits tax on its profits are not taxable in the hands of the recipient.

Interest tax at 15% is levied, generally, on interest arising in or derived from Hong Kong. This is usually interpreted to mean if the originating cause of the interest payment (e.g. where the credit facilities were made available to the debtor) was in Hong Kong. The person paying or crediting the interest must deduct withholding tax of 15% and account for this to the Hong Kong revenue authorities. There are certain exemptions from the interest tax, including interest payments to the Hong Kong Government or to an authorized bank or company doing business in Hong Kong (in which case the interest is subject to profits tax).

JAPAN *

(1) Taxation of Business Entities

Business entities may be affected by both national and local direct Japanese taxation, but this note is only concerned with the national corporation tax. This tax is levied on domestic Japanese corporations, and on the Japanese source income of corporations having a permanent establishment in Japan. Not only companies in the ordinary sense, but all types of Japanese organizations with juridical personality, and also unincorporated organizations having designated representatives or managers are subject to corporation tax. For example, a commercial partnership organized in Japan is subject to corporation tax. In a commercial partnership the partners have unlimited liability and the partnership executes articles of incorporation and must register with the Judiciary Bureau. In an ordinary partnership each partner is taxed directly on his or its share of income.

A "Japanese corporation" (for tax purposes) is a corporation incorporated under the laws of Japan, and it is subject to corporation tax on its worldwide income (excluding any foreign source income that is exempted from Japanese tax by a tax treaty). A foreign or non-Japanese corporation (for tax purposes) is liable for Japanese corporation tax only on its Japan source income. "Permanent establishment" is a term used in double-taxation treaties and generally includes: an office; factory; workshop; branch;

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* Generally: Pechman and Keimei Kaizuka, essay on Japanese taxation in "Asia's New Giant" published by the Brookings Institution (1976).

warehouse; or other fixed place of business. Except for construction projects of more than a year's duration, a foreign corporation having a permanent establishment in Japan, is liable for corporation tax on all its Japan source income whether or not related to the permanent establishment. (In international tax terminology this is called the "force of attraction" principle). But under some tax treaties between Japan and other countries, Japanese corporation tax is levied only on Japan source income related to the permanent establishment. (In international tax terminology this is called the "effectively connected" principle).

The ordinary rate of corporation tax is 40%, but there is a reduced rate of 30% on income earmarked for dividends (including taxable stock dividends). A foreign branch is liable for corporation tax at 40%.

Generally capital gains are subject 100% to corporation tax, and capital losses are deductible.

A corporation liable for Japanese tax should apply to its district national tax office for permission to use a "blue form" tax return. This return has special privileges including carry forward and carry back of losses.

(2) Taxation of Foreign Investments

In this section we consider income received in Japan from a source outside Japan. However, in certain cases income may be exempted from Japanese taxes by a tax treaty between Japan and

another country.

If a corporation qualifies for a blue form return, it may be entitled to special deductions (up to 50% of taxable income) including: 70% of the sale or licensing of patent rights or know-how; 30% of the revenue from the use of copyrights; 20% of the fees for planning, consulting or supervising construction.

Income from foreign investments received by a Japanese corporation may have suffered foreign tax e.g. a foreign withholding tax; foreign corporation tax. The Japanese corporation can either: (a) claim a foreign tax credit in respect of the foreign withholding taxes paid, against Japanese corporation tax and a local Japanese tax called inhabitants tax (17.3% of the corporation tax), or (b) deduct the foreign withholding tax from taxable income. These reliefs are not available to a foreign corporation. The amount of the foreign tax credit is limited to the amount of Japanese corporation and inhabitants tax attributable to the net foreign source income from all the countries from which the Japanese corporation receives such income. Any excess credit or foreign taxes may be carried back or forward for 5 future years.

Subject to a lower percentage under a tax treaty, if a Japanese corporation owns at least 25% of the voting shares of a foreign subsidiary, the foreign taxes which can be credited or deducted also include any underlying foreign corporation tax.

The formula for computing the credit for the underlying foreign corporation tax is as follows:--

Let T be the foreign corporation tax paid by the foreign subsidiary, P the pre-tax income of the subsidiary, C the credit for the underlying foreign corporation tax on the dividend and D the dividend received by the Japanese parent.

Then:

$$\frac{C}{T} = \frac{D}{(P-T)}$$

(3) Taxation of Shareholders

Dividends and interest paid to residents are generally subject to a 20% withholding tax. Until 31st December 1980, certain dividends and interest may be taxed separately at the option of a resident taxpayer or of a non-resident taxpayer having a permanent establishment in Japan (and also in certain other situations), and the withholding tax is then 35%. (Reference: Japanese Taxes 1978, Japanese Ministry of Finance, p. 61).

A Japanese corporation (but not a foreign corporation) may credit withholding taxes by other Japanese corporations or banks against corporation tax (and any excess of withholding tax is refundable).

A taxpayer can credit 10% of dividends against income tax, but if ordinary income exceeds 10 million yen a credit of only 5% applies to dividend income up to the amount that the ordinary taxable income exceeds 10 million yen. The distribution of profits from an investment trust is not available for credit during the years 1971 to 1980.

(4) Foreign Undistributed Income

By legislation which came into effect in 1978, the undistributed income of a foreign subsidiary of a Japanese company may be attributed to the Japanese company, (in proportion to its holding in the subsidiary) and form part of the income of the latter for corporation tax purposes. The conditions for this are:

(i) The Japanese company owns directly or indirectly at least 10% of the stock of the subsidiary, and more than 50% of the stock of the subsidiary is owned directly or indirectly by Japanese corporations and residents.

(ii) There is no attribution of tax in certain situations e.g. if the subsidiary has an office or other fixed facility in the foreign country; and its management and control is in the country where its chief office is located; and it conducts its business mainly there (or in certain cases (e.g. banking, insurance, shipping, air transport) principally with persons other than related persons by Japanese tax law).

The purpose of these provisions is to discourage the accumulation of funds in a "tax haven" by the use of a foreign subsidiary in that country, thus producing deferral of taxes until such time as any repatriation of funds is made from the tax haven subsidiary to the Japanese company.

(5) Corporate Groups and Reorganizations

There are no provisions for group corporation tax assessments.

So losses of one company of a group or consortium cannot be set off against profits of another for tax purposes.

In the case of the absorption of one company by another, or the amalgamation of two companies, assets may be transferred at book value in a tax free "roll-over" to the acquiring company. If a foreign company which has a permanent establishment in Japan forms a wholly-owned Japanese subsidiary, assets may be transferred to the subsidiary at book values on a roll-over basis. Operating losses do not carry over to the acquiring company. Any excess of fair market values over book values in a transfer of assets, or in a corporate liquidation, is taxed at 30% corporation tax.

(6) Tax Incentives

A special credit up to 10% of corporation tax is available to Japanese and foreign corporations doing business in Japan for increases in expenses of research and for the training costs of computer programmers and systems engineers. Tax deferred reserves, calculated as a percentage of exports, are permitted to corporations with paid up capital not greater than 1 billion yen. These reserves are export incentives. There are also tax deferral reserves for overseas market development for small and medium-sized businesses.

Tax deferred reserves are permitted to Japanese companies for certain kinds of foreign direct investment in certain developing countries (made otherwise than mainly for tax avoidance). The reserve is a percentage of the investment cost, and varies for different

kinds of investment. The percentage is 100% for the acquisition of stock in a foreign company exclusively engaged in prospecting for natural resources.

(Reference: Japanese Taxes 1978, Japanese Ministry of Finance, pp. 86/87).

Netherlands

(1) Taxation of Business Entities and
(2) Taxation of Foreign Investments

Corporation tax (Vennootschapsbelasting) is assessed on the income and capital gains of a resident business entity, and in whatever form obtained and whether the source is within or outside the Netherlands. The rates for a company or a branch are:

0 --> 40,000 Df.	45%
40,000 --> 50,000	60%
50,000 -->	48%

A Dutch company or branch of a foreign enterprise may be tax exempt from dividend income and gains from the sale of shares from a subsidiary which is not an investment company, if it has a holding in the subsidiary of at least 5% of the issued share capital. If the other company is foreign, the exemption applies only if it is subject to some foreign tax (nationally assessed) and the share interest is not merely an investment without any business relationship.

A U.S. company has a wholly-owned subsidiary resident in the Netherlands and the subsidiary has a subsidiary company (compañia de responsibilidad limitada) in Spain, in which it holds more than 5% of the share capital. The Spanish subsidiary pays tax at 32%. Then income received by the Netherlands subsidiary is exempt from

Netherlands tax. The income so exempt from Netherlands tax is re-invested in Hong Kong which only applies corporation tax to Hong Kong source income. [See the notes on Hong Kong].

Many U.S. and U.K. multinationals have used the tax advantages of a Netherlands subsidiary. If it complies with certain qualifying rules, a resident investment organization may be exempt for Dutch tax, including withholding tax from Netherlands corporations. The main qualifying rules are that: the organization's activities must consist of investment funds to the extent of 90% of all its investments and loans; and its investment in non-resident companies or foreign funds must not exceed 25%. A non-resident investment fund or company cannot be a shareholder in a Netherlands investment organization, if 25% or more of the share capital of the non-resident fund is held by Netherlands residents.

As a consequence of tax treaties, a Canadian corporation can form a Netherlands holding company to hold interest in other affiliates of the Canadian corporation in other countries, and ultimately to repatriate such income from the Netherlands holding company to Canada without Netherlands withholding tax.

The Netherlands has a very broad network of tax treaties with some very favourable rates of withholding tax, e.g. no withholding tax on interest or royalties, and no withholding taxes of any type on any income payments to a Netherlands Antilles corporation.

(3) Taxation of Shareholders

Generally, a 25% withholding tax applies to dividends on securities issued by companies resident in the Netherlands. The rate may be reduced by a tax treaty in the case of a non-resident shareholder, if the income is not effectively connected with a permanent establishment in the Netherlands.

Dividends paid to resident companies (and mutual insurance companies) are tax exempt provided the receiving and paying companies have no mutual shareholders and the receiving company owns at least 5% of the share capital of the paying company.

A branch of a foreign corporation is not required to deduct withholding tax from a repatriation of its income.

A shareholder resident in the Netherlands is entitled to tax relief for foreign taxes. This may be under a tax treaty or applied unilaterally. The amount of the relief has an upper limit. Let F be the amount of the taxed foreign income; let I be total taxable income, let T be the Netherlands tax on I, and L be the upper limit. Then L is given by the formula:

$$\frac{L}{T} = \frac{F}{I}$$

In the case of remittances other than by dividend, interest (excluding mortgage interest on foreign realty) and royalties, e.g. foreign branch profits the tax relief is a fixed amount namely TF/I.

(4) Corporate Groups and Reorganizations

A Netherlands company may be authorized to make a consolidated tax return with any wholly-owned Dutch subsidiary. The authorization may contain conditions as to set-off and carry-forward of losses.

If a company transfers the whole or part of its business in exchange for shares in another company at book values for tax purposes, there will be a roll-over and deferment of tax until a future sale (after three years) creating a gain against the book values on transfer. If there is an alienation within three years, no tax is payable on the original transfer or on the alienation.

(5) Tax Incentives

New Dutch legislation on investment incentives (Wet Investeringsrekening) was passed in 1978. (Reference: Brassem, 17 European Taxation, pp. 239-247). The general system is that annually a certain percentage of personal income tax and corporate income tax will be appropriated to a special investment account from which subsidies will be paid to taxpayers with reference to qualifying investments. The subsidies are first set-off against the taxpayer's income tax liability and then paid out in cash. Those liable for Netherlands personal or corporate income tax may qualify for subsidies, and so this includes foreign permanent establishments in the Netherlands. But no subsidy is available for direct or indirect investment in a foreign permanent establishment outside the Netherlands.

There are detailed rules as to the kinds of investment that can benefit, but in general terms the intention seems to be to subsidize the acquisition or improvement of an asset and production costs for the construction of an asset, so far as these are borne by the enterprise. The whole system seems to be complex and to require a sophisticated governmental administration.

SWITZERLAND*

(1) Taxation of Business Entities

The Swiss Confederation consists of 22 Cantons and over 3,000 Communes all of which have a substantial amount of independence. The Cantons have the primary role in determining direct taxation on business entities, and this varies quite widely from one canton to another, both as to rates and principles.

A corporation operating in Switzerland may be liable for tax on its income and net worth (i.e. capital plus reserves) at federal, cantonal, and communal levels, and so it is not possible to give a simple general statement of Swiss direct taxes on business entities.

A Federal Defence Tax (herein referred to as F.D.T.) is levied on income and net worth, and the income portion is graduated with regard to the relationship between profits and invested capital.

In general, but subject to international double taxation agreements, corporations or legal entities organized in Switzerland, and registered in a commercial register, are liable for taxation on all income and capital, whether or not arising in Switzerland. A non-resident company is taxed on income attributable to a permanent establishment in Switzerland and on income related to Swiss realty. According to the F.D.T. statute, but subject to international double taxation agreements, a permanent establishment is a fixed place of doing business (e.g. a branch) where an important part of the activity of the business entity is carried on. Branch income to be taxed must

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*Dussand Bird, Switzerland's "Tax Jungle", 27 Can. Tax J., 46.

be effectively connected with the operations of the branch. A permanent establishment must be registered in a commercial registry, and is treated as a separate entity subject to business taxation at normal rates.

F.D.T. ranges from 3.63% to 9.8% (when the net profit is 23.48% or more of the net worth). The maximum rates of the total federal, cantonal and communal tax burden vary from 26% to a high of 42% in Zurich.

Intercantonal double taxation is avoided as far as possible by jurisdictional rules as to which canton is the one entitled to collect tax in different circumstances.

F.D.T. and most cantonal taxes are levied on capital gains as on ordinary income, but a special capital gains tax is levied in some cantons.

(2) Holding Companies

Holding companies in Switzerland (i.e. companies whose main purpose is to participate through investment in other companies) enjoy considerable tax advantages. The Swiss theory is that the subsidiaries have paid tax on net profits and so it would be unfair to tax the holding company as well.

For purposes of F.D.T., a holding company which has a substantial participation in another company, Swiss or foreign (i.e. at least 20% of authorized capital or with a market value of at least 2 million Swiss francs) is tax exempt on dividends from an affiliate

and taxes are reduced proportionately for lesser participations.

Holding companies are exempt from most cantonal and communal corporation income taxes, but not from cantonal or from communal net worth taxes, although these are at a reduced rate in most cases.

Mixed holding companies (i.e. companies which own substantial shareholdings in one or more corporations, Swiss or foreign, but also carry on their own operations) may also obtain tax reductions, for substantial holdings, in most cantons, but only a few cantons grant mixed holding companies a reduction in net worth tax.

(3) Domiciliary Companies

A domiciliary company is foreign owned and has its legal domicile in Switzerland, but it has no office space in Switzerland and conducts no business activities there. Generally it will be only a nameplate and a local agent will represent the foreign located management. Typically, its business may be patent holding, copyright marketing, sales invoicing, or investment activities. Some cantons may allow more office installation, but there must be no Swiss source business income or real property interests connected with it.

Domiciliary companies receive favourable tax treatment from most cantons (e.g. reduced net worth taxes in lieu of corporate income and net worth taxes).

The following are examples of the uses of domiciliary companies:

(a) An international sales company buys goods from manufacturing subsidiaries to sell in other countries. The differences between

purchases and sales are accumulated at a Swiss domiciliary company and only low taxes are paid.

(b) A Swiss domiciliary company is used by an international company to hold trade marks and patents. International double taxation agreements reduce foreign taxes, and special arrangements in Switzerland reduce Swiss taxes, so that the licence fees and royalties will be taxed at favourable rates.

(4) Service or Auxiliary Companies

These companies do not have any commercial or industrial operations of their own, but perform auxiliary functions for a closely connected foreign enterprise. If the auxiliary companies are also engaged in management, marketing, publicity, technical assistance, finance, they are also called service companies. Such companies receive specially favourable tax treatment in certain cantons.

The problem with this kind of company is one of transfer pricing, i.e. whether the services provided are charged at fair market value, or at an artificially high or low level to reduce the multinational taxes of an international company. The Swiss federal tax administration have established guide-lines to combat the declaration of artificially low income for tax purposes (producing a constructive or deemed dividend subject to a withholding tax of 35%)and some cantons also have rules with a similar objective.

In certain cases, after advance negotiations with the taxation authorities, it may be possible to establish service, auxiliary or domiciliary companies in Switzerland with exclusively foreign source income, and subject to total effective income tax rates which, depending on the canton, will vary from perhaps 14% to over 20%.

(5) Taxation of Foreign Investments

Income effectively connected with a bona fide permanent establishment outside Switzerland (e.g. a foreign branch) is not taxed in Switzerland. A foreign branch is treated as a separate entity for tax purposes. Although income of such a foreign branch will not be included in Swiss taxable income, it will be taken into account in determining the ratio of income to capital, and this ratio determines the effective rate of income tax.

Switzerland has international tax agreements with numerous foreign countries under which relief from double taxation is available either by application for relief or by a credit against Swiss taxes on related income (or both).

Income from foreign securities circulating in Switzerland is taxed at 3%.

(6) Taxation of Dividends and Interest

An Anticipatory Tax of 35% is withheld by corporations from payments of dividends, and interest on bonds, debentures and loans (including a loan from a foreign parent to a Swiss subsidiary). This withholding tax may be credited by the shareholder against cantonal and communal taxes, or (if this is insufficient) refunded to individuals or corporations resident in Switzerland. The rates of withholding tax may be reduced by international tax agreements.

There is no withholding tax on royalties and fees paid to other countries if the fees are not for services rendered in Switzerland. This may be altered by international tax agreements. Also payments of

royalties and fees between related corporations may be regarded as transfers of profits, and so taxed.

Distributions to shareholders on the liquidation of a company out of liquidation surplus are subject to 35% Anticipatory Tax, like dividends.

(7) Tax Incentives

The Swiss Confederation and Cantons agreed in 1948 to offer tax incentives to new business for periods up to ten years where the new business contributes to the economy of the canton concerned. There is no scheme of general tax incentives, but tax concessions may be obtained directly from certain cantons (affecting canton taxes but not F.D.T.).

United Kingdom

[Great Britain consists of Scotland, England and Wales. The United Kingdom consists of Great Britain and Northern Ireland (but not the Channel Islands and the Isle of Man)].

(1) Taxation of Business Entities

The U.K. income taxes on business entities are corporation tax and personal tax. The principal statute is the Income and Corporation Taxes Act 1970 (herein referred to as I.C.T.A.). Tax is levied on a "preceding year" basis which complicates the system.

A partnership in the U.K. does not have a legal personality separate from the individual members, and the members are assessed for personal income tax on their respective shares of the partnership profits. But, for tax purposes, a partnership is treated to some extent as a separate entity. If a trade or profession is carried on, a joint assessment is made in the partnership name, and the tax liability is the joint liability of all the partners (I.C.T.A. s.152). Physical partners pay at the personal tax rates and corporate partners pay at corporate tax rates. If a partnership which is managed and controlled outside the U.K. carries on any trading operations in the U.K. it is taxed like a non-resident person carrying on business in the U.K. (whether or not a partner is resident in the U.K.) and an assessment can be made on a U.K. resident partner (I.C.T.A.,

s. 153). A non-resident partnership is in fact in much the same tax position as a non-resident company. But if a U.K. resident company is a member of a foreign partnership, the company is taxed as a U.K. resident on its share of partnership profits (I.C.T.A. s. 155(6)). There is substantial case law on the determination of the situs of control and management of a partnership. (Reference: Sumption, Taxation of Overseas Income and Gains, (2d ed.) ch. 4).

There is considerable and rather confusing case law on what determines the residence of a corporation. Generally, a corporation resides where the controlling power and authority exists and is exercised to some substantial degree. The place of incorporation is only one factor to be taken into account, and the place where the directors meet may be a factor of greater weight. [See these notes as to other countries which place greater emphasis on the place of incorporation]. It follows that: a corporation may be resident in more than one place, and it may change its place of residence; a company incorporated outside the U.K. may be resident in the U.K. for U.K. tax purposes. If a corporation is resident in the U.K. it requires the consent of the U.K. Treasury: to cease to be U.K. resident; to transfer any of its trade or business to a non-resident; to permit a controlled non-resident corporation to issue shares or debentures; to permit the transfer of shares or debentures in a controlled non-resident corporation (I.C.T.A. s. 482, and it is a criminal offence for any person, within or outside the U.K., to be a party to any act that to his knowledge results in something unlawful under the section).

As from 1965 U.K. resident companies are subject to corporation tax on their trading profits from within and from outside the U.K. (as determined for tax purposes). Due to the important adjustments that are needed to transform accounting profit into taxable income for corporation tax purposes (e.g. capital allowances on machinery and plant, industrial buildings, mines, oil wells, scientific research), it has been said that U.K. corporation tax is not a true "profits" tax but is "half-way towards a flow-of-funds tax" (Reference: The Structure and Reform of Direct Taxation--the "Meade Report", 1978, p. 229). [A similar comment could be made about corporation tax in other countries]. Subject to any relevant international tax agreement, a company that is not resident in the U.K. but which has a permanent establishment in the U.K. (e.g. a branch) is liable to corporation tax on income attributable to the branch, and to income tax on any other U.K. source income.

The current rate of corporation tax is 52%. There is a reduced rate of 42% on taxable profits less than £60,000 with marginal relief up to £100,000.

Taxable capital gains (less capital losses) of a resident U.K. corporation are liable to corporation tax at 30%. A non-resident company is similarly taxed on capital gains on the disposal of U.K. situated assets used for the purposes of business carried on in the U.K. or for the purposes of a branch or agency in the U.K.

A corporation may not be due enough corporation tax against which to apply all the A.C.T. on a distribution e.g. where UK corporation tax is reduced by tax incentives, or where there is foreign source income or a foreign tax credit. Then the balance of A.C.T. is an effective net cost to the corporation making the distribution.

(2) Taxation of Foreign Investments

A resident corporation may be liable for capital gains tax on the disposal of any form of property, whether or not situated in the U.K.

Foreign branch profits of a U.K. corporation are subject to U.K. corporation tax (whether or not remitted to the U.K.). Foreign source profits of a non-resident subsidiary are not usually subject to U.K. tax unless repatriated as dividends, royalties, etc. (see also section (4) of this note, on foreign undistributed income).

Foreign income may have suffered foreign taxes (e.g. corporation tax, withholding tax) before being received in the U.K., and the repatriated amounts may also be subject to U.K. income tax. Various reliefs are available to U.K. resident taxpayers under U.K. tax laws in respect of this kind of double taxation (where foreign taxes correspond to U.K. income or corporation taxes). These are:

(a) Relief under an international tax agreement between the U.K. and another country. Such an agreement may provide that certain income will be taxable in one of the two countries and will be exempt in the other, and it may provide that certain other income is taxable in both countries, but that a foreign tax credit is allowed against U.K. taxes on the same income or gains.

(b) Where there is no applicable international tax agreement, a tax credit is available under the U.K. tax laws (I.C.T.A. s.498).

(c) Where neither (a) nor (b) applies, certain foreign taxes (e.g. withholding tax) may be deducted from taxable income.

The foregoing reliefs apply to foreign withholding tax (e.g. withheld on dividends paid by a foreign subsidiary to a U.K. parent). If the U.K. company or its parent holds (directly or indirectly) at least 10% of the voting power of the foreign corporation, the foreign taxes qualifying for credit will include (in addition to foreign withholding taxes) other foreign "underlying" taxes on the income out of which the dividend was paid (e.g. foreign corporation tax). (I.C.T.A., s. 498(4)). Similar relief applies to underlying taxes related to a third company in a third country (in which the second company has a 10% interest) and so on for a fourth company, fifth company, etc.

The amount of taxable foreign income (in the case of a dividend distributio is equal to (i) the cash dividend by the U.K. taxpayer (received from the foreign company); plus (ii) the foreign tax credit (received, by set-off, from the U.K. revenue authorities). This sum is the amount of taxable income in respect of the dividend which must be included in the assessment of the U.K. taxpayer.

Suppose that a U.K. resident corporation receives a dividend of 100 from a Hong Kong subsidiary in which it has a 15% holding. The Hong Kong subsidiary paid Hong Kong corporation tax at 17% on the income out of which the dividend was paid. There is no Hong Kong withholding tax on dividends. Thus the taxable income related to the dividend is:

Cash dividend	100
Underlying corporation tax	20.5
	120.5

The corporation tax on 120.5 at 52% is 62.7 and the amount of the tax credit is 20.5. So the U.K. tax due by the U.K. corporation in respect of the dividend is (62.7 - 20.5) = 42.2.

(3) Taxation of Shareholders

If a U.K. resident company makes a "qualifying distribution" (after 1973) it is liable to pay "advance corporation tax" (A.C.T.). Virtually all distributions are qualifying distributions other than issues of bonus redeemable shares and bonus redeemable debentures. A typical qualifying distribution is a cash dividend.

The rate of A.C.T. is 3/7ths of a qualifying distribution. The amount of A.C.T. paid by a corporation can be set-off against the full amount of ordinary corporation tax at 52%. Ordinary corporation tax minus A.C.T. is usually called "mainstream corporation tax" (M.C.T.). Thus A.C.T. is, in effect, treated as an instalment of ordinary corporation tax. [Compare A.C.T. with the "two-rate" system mention in the note on West Germany].

In 1973-74 a new system of personal income tax was introduced in the U.K. (usually called the "unified system") and this included the concept of a "basic rate" of personal income tax. Not all personal income is taxed at the basic rate and higher rates apply to personal incomes over a certain level. The basic rate is fixed annually by the U.K. Parliament. The basic rate is 30%

A dividend received by a shareholder is taxable personal income, and also the company paid A.C.T. on the amount of the dividend. So there is an element of double taxation on the same income. To mitigate this, part of the corporation tax payable by the company in relation to the distribution is "imputed" to a U.K. resident shareholder in the form of a tax credit (usually called an "imputation credit"). The system is so set up that the A.C.T. equals the imputation credit and an individual whose personal tax rate equals the basic rate pays no personal income tax on the dividend. This can be illustrated by an example. Let the cash dividend be D and let the shareholder's tax rate be the basic rate of 30%. The shareholder's taxable income (relative to the dividend) is equal to the cash dividend (received from the corporation) plus the imputation credit (received from the revenue). The imputation credit equals the A.C.T. which is 3D/7. The shareholder's personal tax on the dividend is 30% of (the cash dividend plus the A.C.T.) minus the imputation credit, i.e. $\frac{30}{100}(1 + 3/7)\,D - 3/7\,D = 0$

A non-resident shareholder is not entitled to an imputation tax credit, unless an international tax agreement so provides.

The term "franked payment" is used to describe the qualifying distribution plus the related A.C.T. Conversely, the term "franked investment income" is used to describe a dividend received by one U.K. company from another U.K. company plus the imputation credit. A distribution received by one U.K. company from another U.K. company is exempt from corporation tax. A.C.T. is only payable in respect

of the excess (if any) of franked payments over franked investment income. If franked investment income exceeds franked payments in a given tax year, the difference is called "surplus franked investment income" and this can be carried forward.

(4) Undistributed Income

A "close company" is, in general terms, a U.K. resident company which is controlled by either (i) 5 or fewer participators or (ii) where all the participators (however many) are directors (I.C.T.A. s. 282 et seq.). A participator is a person having a share or interest in the capital or income of the company (including a loan creditor other than a bank lending in the ordinary course of business).

The most important provisions are that all or part of its undistributed income (after paying corporation tax and after allowing for certain business requirements) may be apportioned, and attributed directly to the shareholders and taxed as their income. A company controlled by one person or a small group can sometimes arrange its affairs to reduce taxes more easily that a larger company with more diversified control. It might, for example, retain profits beyond its business needs; disguise a distribution as directors' fees or other form of deductible expenditure.

A company is not a close company (even although closely controlled) if 35% of its voting shares are publicly held and quoted on a

recognized stock exchange.

[For some information on tax planning in regard to close companies, see e.g. Hepker, Tax Strategy for Companies, pp. 95-118; Lawton and Sumption, Tax Planning (7th ed.), pp. 69-79 and Appendix A].

(5) Corporate Groups and Reorganizations

There are certain tax benefits available to a "51% group" (i.e. a U.K. resident parent owning at least 51% of the share capital of a U.K. resident subsidiary; a "75% group" (i.e. a parent owning at least 75% of the share capital of a group); a "consortium" (i.e. 5 or fewer U.K. resident companies owning at least 75% of the share capital of a U.K. resident trading or holding company). There is no limit to the number of subsidiaries or trading companies but, in a group, the parent and at least one subsidiary must be a U.K. resident, and in a consortium, at least one trading company or a holding company must be a U.K. resident. If these conditions are satisfied any other companies in a group or consortium need not be U.K. residents.

The main examples of the tax benefits available are (1) "group relief" and (2) special treatment of A.C.T.

(1) Group relief is available to a 75% group and to a 100% consortium, and it enables trading losses and other items to be surrendered between U.K. resident companies in the group or between a U.K. resident trading company or holding company and a

U.K. resident member company in a consortium, thus minimizing the overall tax burden of the group or consortium.

(2) Dividends and charges on income may be paid between U.K. resident companies in a 51% group or a consortium without payment of A.C.T.

If company A acquires shares or debentures in company B in exchange for shares and debentures in B, and A has more than a 25% interest in A after the exchange, the former shareholders of B may obtain a deferral (or "roll-over") of capital gains tax on their new shares (i.e. until such time as they may dispose of these new shares).

(6) Offshore Oil and Gas Taxation

Petroleum revenue tax (P.R.T.) is, in general levied at 60% on profits from oil and gas extracted anywhere in the U.K. or designated areas of the U.K. continental shelf after 12 November, 1974. P.R.T. is deductible in computing income for corporation tax purposes. The basic legislation is the Oil Taxation Act, 1975.

The topic is, naturally, rather complex and for details reference should be made to specialized studies, e.g. Hallyar and Pleasance, U.K. Taxation of Offshore Oil and Gas (1977).

United States

(1) Taxation of Business Entities

Business in the U.S. may be affected by federal corporation income tax and personal income tax, and also in many jurisdictions to a significant degree by state and local corporation and personal income taxes. The main federal tax law is the Internal Revenue Code (I.R.C.).

A partnership is not subject to tax per se (like a corporation), unless it is treated by the Internal Revenue Service (I.R.S.) as an association taxable as a corporation (I.R.C. s. 7701). The individual partners are assessed for income tax on their respective shares of partnership profits, the computation of total income being made at partnership level and allocated among the partners. Physical partners pay personal income taxes and corporate partners pay corporate income taxes.

In certain circumstances, there may be tax advantages in using a partnership structure if a foreign company wishes to acquire an interest in a U.S. company. For example, X is a foreign corporation which acquires a 60% interest in Y a U.S. corporation. X organizes S a U.S. subsidiary corporation. S obtains a loan to pay for a partnership interest in Y. S is engaged in a trade in the U.S. because the partnership is so engaged, and therefore S can deduct the

interest on the loan from its taxable income.

If profits are distributed by a U.S. partnership to a U.S. partner (i.e. U.S. citizen, resident alien, U.S. corporation) there is no U.S. withholding tax, but a distribution to a foreign partner may be subject to withholding tax (e.g. if the partnership was organized for passive investment and not to do business). However, if a U.S. partnership is engaged in business, a foreign partner will likely be considered as being engaged in business in the U.S. and so subject to normal U.S. taxation and not to withholding tax (I.R.C. s. 875).

The I.R.S. can determine by U.S. law and concepts where a foreign business entity is to be regarded as a partnership for U.S. tax purposes, whatever the status of the entity may be in foreign law. U.S. source payments to a foreign partnership (not participating in trade or business in the U.S.) are subject to withholding tax, even if the foreign partnership has a U.S. partner. If the foreign partnership is engaged in business in the U.S., then its income related to such business is subject to normal U.S. taxation and not to withholding tax.

A corporation is liable for federal corporation tax on its worldwide income if it is a U.S. corporation (i.e. incorporated under state or federal law or the law of a territory). A foreign corporation engaged in trade or business in the U.S. is liable for corporation tax on income "effectively connected" with U.S. trade or business of the corporation (whether or not the income has a U.S.

source). The corporation may also be liable for a withholding tax of 30%, or such lower rate as may be provided in an international tax agreement, on U.S. source income not effectively connected with U.S. trade or business of the corporation.

Liability to state taxes exists if a corporation is a domestic corporation (i.e. incorporated in the state) or does business or has income producing assets in the state. Assessment is based on income or on a formula. Some states (Alaska, California, and Oregon to a certain degree apportion world-wide consolidated income of an entire corporate group to the state where it is considered that a "unitary" business exists.* The apportionment is based on the ratio of property, payroll and sales in that state to the worldwide property, payroll and sales of the group. In other states, while reference is made usually to a three-factor formula based on the income of a corporation or a US consolidated return group, the practice is by no means uniform and some states use a one-factor or two-factor apportionment basis. Most states and some cities levy income taxes. These taxes range from 4% to 12% and they are deductible from income for federal tax purposes.

Unless otherwise indicated this note deals only with federal corporation tax.

Corporation tax applies to U.S. branches of foreign corporations. The branch may repatriate after-tax profits without withholding tax (but this may not apply if the U.S. income is at least 50% of the total income of the foreign corporation).

The 1979 rates of corporation income tax are:

First $25,000	17%
$25,000 - $50,000	20%

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*Wood, Unitary Tax Controversy (1977) 25 Can. Tax J., 271.

$50,000 - $75,000	30%
$75,000 - $100,000	40%
over $100,000	46%

(2) Taxation of Foreign Investments*

In this section we consider income received in the U.S. from a source outside the U.S. Such income may already have suffered foreign taxes, e.g. foreign withholding taxes; foreign corporation tax.

Situations may arise where the same income will be subject to both U.S. and foreign income taxes, and foreign tax credits may be available against U.S. income tax liability to give relief from such double taxation.* As an alternative to a credit, directly paid foreign taxes (e.g. withholding tax on a dividend) may be deducted from income subject to U.S. income tax, and the taxpayer must elect between a credit and a deduction.

Income from foreign investments may, of course, take various forms e.g. business income repatriated from a foreign branch; interest on a loan; dividends; royalties; rental income; gains from the sale of property; income from "passive" (i.e. portfolio) investments. Some such income may be exempt from U.S. taxes (and taxed in the foreign jurisdiction only) under an international tax agreement.

Foreign (double-taxation) tax credits are available to domestic corporations, U.S. citizens and resident aliens. Also a foreign corporation engaged in a U.S. trade or business may obtain a U.S.

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*Hammer and Chan, U.S. Foreign Tax Credit, 26 Can. Tax J., 433.

*Patrick, U.S. Tax Policy and Foreign Investments, 5 Denver J. of Int. L. and Policy, 1.

foreign tax credit (applicable only by set-off against tax on income from such trade or business) for taxes paid to a foreign country or a U.S. possession on foreign source income effectively connected with that trade or business.

The types of taxes which can be the subject of a foreign tax credit are: --

(a) foreign income taxes paid by the claimant (e.g. withholding taxes; branch taxes paid to a foreign government).

(b) "underlying" foreign taxes (e.g. a proportion of the foreign corporation tax paid by a foreign subsidiary on the income out of which the dividend was paid) where a U.S. corporate shareholder owns at least 10% of the voting power of a foreign corporation.

To obtain a credit, the foreign tax must be in the category of income tax, and questions may arise as to whether e.g. payments by oil or mining companies to foreign governments are income tax or really something else, such as disguised royalties.

There is a limit on the foreign tax credit determined by the formula:

$$\frac{\text{foreign taxable income}}{\text{total taxable income}} \times \text{U.S. tax (on total taxable income).}$$

This formula is applied on the totals of all the countries involved. So an operating loss in foreign country A can be deducted from an operating profit in foreign country B in order to arrive at the total foreign taxable income in the two countries. Excess credit can be carried back two years and forward five years.

There are complex rules under the Internal Revenue Code, s.861 to determine "source" of income, which may require a U.S. taxpayer to apportion some domestic deductions between foreign and domestic source income.

Taxes paid by a multi-national corporation can be affected by the transfer pricing policy adopted when goods or services are transferred between one unit and another of the multi-national. Section 482 of the I.R.C. permits the realloaction by the I.R.S. of gross income, deductions, credits, or allowances between "organizations trades or businesses" of a multinational, if it is determined that this is necessary "to prevent evasion of taxes or clearly to reflect the income of any of such organizations trades or businesses". The application of this section has produced a complicated body of decisions and administrative rulings.

Illegal payments made with respect to foreign operations to foreign government officials are treated as a dividend to the U.S. shareholder.

If a person participates in or co-operates with an international boycott as a part of doing business in a foreign country, that person may lose foreign tax credit and certain other benefits. Such participation or co-operation occurs when a person, in order to do business in one country, agrees not to do business with a specified country, or agrees not to hire employees, or do business with other companies whose employees are of a specified nationality, race or religion.

(3) Foreign Undistributed Income

X is a U.S. multi-national corporation which establishes a foreign base subsidiary in a "tax haven" country (which has low

corporation tax or none at all) not in order to trade in the tax haven country, but to be a collecting point for revenue from activities such as provision of management services, granting and use of patents and know-how, processing bank lending or insurance business, with a view to accumulating the income of the subsidiary and not repatriating it. If X was only taxable on repatriated income, it would be able to defer tax on the income of the subsidiary until repatriation.

But there are certain provisions in U.S. tax law whereby foreign undistributed income may be attributed to and taxed directly as the income of a U.S. shareholder. The main provisions involve two concepts: (i) a "controlled foreign corporation" and (ii) "Subpart F income". A U.S. shareholder of a controlled foreign corporation may be directly subject to U.S. tax on a share of undistributed Subpart F income. The provisions are complicated and so are only sketched in this note.

In a controlled foreign corporation 50% of the voting power of all classes of stock is owned directly or indirectly by "U.S. shareholders". A U.S. shareholder (for this purpose) is a U.S. citizen resident, domestic corporation, partnership or trust that owns at least 10% of the voting power of the controlled foreign corporation. If controlled foreign corporation X owns at least 50% of foreign corporation Y, Y is also a controlled foreign corporation.

The main categories of Subpart F income are: "foreign base company" income, and income from the insurance of U.S. risks. Foreign base company income includes non-U.S. source income from

certain "passive" investment income of a holding company; sales of personal property produced, and sold for use, outside the country of incorporation of the controlled foreign corporation; managerial and other services for a related person outside the country of incorporation of the controlled foreign corporation; the use or chartering of ships or aircraft in foreign commerce.

In the case of a foreign acquisition of a U.S. corporation, a U.S. holding company might be established to make the acquisition and incur the borrowing expense. If this holding company acquires at least 80% of the "target" company, the two may file a consolidated return, so that the interest expense can be set off against the earnings of the acquired company.

The basic U.S. withholding tax on distributions of dividends, interest, etc. to non-residents is 30% unless reduced by a tax treaty.

(4) Corporate Groups and Reorganizations

A group of affiliated corporations (if at least 80% of the voting stock and at least 80% of each class of non-voting stock is owned by the common parent) may file a consolidated tax return. This has the advantage that a loss by one of the corporations can be offset against profits of another. If a U.S. corporation receives a dividend from another U.S. corporation and both are members of the same affiliated group, the dividend is tax-exempt. If they are not affiliated, 15% of the dividend is subject to tax.

Generally, if a U.S. corporation sells or exchanges its assets, this would be a taxable transaction. But there are various forms of acquisition or reorganization which do not change the economic position of the corporations or their stockholders and are tax free.

(5) Tax Incentives

There are a considerable variety of tax incentives in the U.S. federal, state, and local. In this note only a few federal incentives will be mentioned briefly.

Domestic International Sales Corporation (D.I.S.C.). There was legislation in 1971 introducing this type of corporation, with tax deferral advantages intended to encourage U.S. firms to increase their exports from the U.S. (so encouraging e.g. U.S. employment rather than foreign employment, in U.S. international business). The D.I.S.C. rules have been significantly changed by the Tax Reform Act 1976.

Possessions Corporation. This is a U.S. corporation which is organized to carry on business substantially in a U.S. possession. (e.g. Puerto Rico). Such a corporation is only taxed on income earned outside the U.S. if remitted to the U.S.

Less Developed Country Corporation (L.D.C.C.). This is essentially a foreign corporation with at least 80% of its income from sources within less developed countries (designated by Executive Order). There are certain tax advantages especially for a controlled foreign corporation that is also an L.D.C.C.

[See also: Patrick, U.S. Tax Policy and Foreign Investments, 5 Denver Journal of International Law and Policy, pp. 1-18; Gifford, U.S. Taxation of Export Operations, 5 D.J.I.L. & P., pp. 19-44; Rhodes, U.S. Tax Aspects of Operating Abroad, 5 D.J.I.L. & P., pp. 45-75.]

VENEZUELA

(1) Taxation of Business Entities

Generally, business income is taxed under Title II Tariff A of the income tax law. Income from mining and petroleum industries (including royalties) is taxed under Title III at a flat rate of 72%. Tariff A is a progressive scale of tax rates running from 15% for the lowest "slice" of income to 50% for the highest "slice". Suppose X is a Venezuelan resident corporation with income of 6,000,000 bolívars. Then the Tariff A computation is:--

100,000	at 15%	15,000
1,400,000	at 25%	350,000
3,800,000	at 30%	1,140,000
700,000	at 35%	245,000
6,000,000		1,750,000

Income of a branch, or other permanent establishment, (whether or not distributed) is taxed at 15% of (taxable income minus Tariff A income tax).

Capital gains of a company are taxable as any other income.

Gross receipts from export sales related to mining and hydrocarbon activities are taxed at the higher of actual sales or the values set by the government for exports from Venezuela.

There are no provisions for taxing companies as a group.

Progressive rates of corporate income tax have been criticized. E.g. the Musgrave Commission on Fiscal Reform for Colombia (1971) recommended for that country: "Elimination or marked de-emphasis of the principle of taxing business entities according to size and past investment, which is now embedded in the graduated scale of rates and excess profits tax structure."

(2) Taxation of Foreign Investments

In general, Venezuela only taxes income derived from economic activities or properties, or any factors originating income, in Venezuela, and the deduction of expenses and losses is similarly territorial. So, income from business activities which does not have a Venezuelan source is (in theory) not taxable. No foreign tax credits are allowed. In regard to sales, the determining factor is where the sale took place. Seemingly, a sale on consignment to a person in Venezuela, with hold-back of title to the consignor, will be regarded as taking place in Venezuela. Examples of costs deemed be incurred in Venezuela are: foreign acquisition of materials for resale in Venezuela; foreign purchase of equipment for use in a business in Venezuela; shipping, insuring, commissions for services related to the importing of goods; operation of ships or aircraft by international transport companies organized in Venezuela.

It seems that the territorial concept of taxation is applied so broadly in Venezuela that there may be no clear fiscal distinction

between income earned in Venezuela and other income. Venezuelan tax rulings have not established clear principles, and in certain cases the management activities of an off-shore business have been ruled liable to Venezuelan tax. On the other hand the territoriality concept seems to be quite strictly applied to the deduction of expenses.

A Ministry of Finance resolution of January 1979 requires any foreign company engaged in activities reserved for National Companies (principally internal commercialization of goods) to present a plan for conversion to a National Company (or be covered by an exception).

(3) Taxation of Dividends and Interest

The general tax on dividends (including loans or deposits to shareholders, unless these are to the benefit of the company) is 15% and there is a 15% withholding tax on distributions by foreign corporations operating in Venezuela (after payment of corporation tax). Dividends on unregistered bearer shares are subject to a withholding tax of 30%. A Venezuelan corporation (including a Venezuelan subsidiary of a foreign corporation) is tax exempt on dividends from other corporations. Stock dividends are tax exempt. Resident individuals are entitled to certain tax credits on dividend income computed as 40% of the tax rate paid by the distributing corporation up to the amount of taxes attributable to the dividend income.

There is a withholding tax of 15% on dividends, on nominative shares, paid to non-residents (including foreign corporations).

There is a 10% withholding tax on interest transmitted from Venezuela to banks and financial institutions.

Royalty income from mining or petroleum is subject to a 60% withholding tax on 80% of the gross payments.

(4) Tax Incentives

Tax incentives are available for certain classes of investment in Venezuela, e.g. (i) construction of low to medium priced dwellings; (ii) capital investment in agriculture, forestry, and fishing; (iii) new industries or industrial development in non-industrialized areas, (iv) capital investment in fixed assets by manufacturing, transport or agricultural countries (generally, a tax credit of 15%); (v) investment in fixed assets by oil and mining companies (a tax credit up to 2% of taxable income); (vi) a tax credit for exports on the percentage of value added in Venezuela.

In 1973 legislation provided that a publicly owned company known as a Sociedad Anónima Inscrita de Capital Abierto: SAICA can receive certain tax benefits, subject to official approval. If at least 50% of the shares are publicly owned, the company may apply for a tax reduction of 25%; if 50% to 60% of the shares are publicly owned, there may be a 30% tax reduction; if 60% to 75% of the shares are publicly owned, the reduction may be 40%; and if over 75% of the share are publicly owned, the reduction may be 50%.

Indirect Taxation

In many countries there are a considerable variety of indirect taxes, e.g. sales taxes of different types and at different levels (retail; wholesale); customs duties; turnover taxes; manufacturers' excise taxes; taxes on gas, automobiles, franchises, payroll; stamp duties on documents; taxes on the formation of companies; licence duties; social security taxes; and so on. These taxes may be imposed at federal; provincial or state; local or municipal levels. They have considerable impact on the economies concerned and on the costs of doing business, both domestic and international, and they add considerably to the complexity of business operations. Indirect taxes such as sales taxes are usually shifted forward, in whole or in part, to the ultimate consumer (by being added on to the cost of the goods or services).

A type of tax which, in principle, has gained considerably in popularity in Western Europe and elsewhere is the "value added tax" (V.A.T.). This tax was first adopted by France in 1945. The French name is "taxe sur la valeur ajoutée" (T.V.A.).

When the European Common Market was initiated by the Treaty of Rome, one of its objectives (as mentioned in the Introduction to these Notes) was the "harmonization" of national tax laws to help to minimize national economic discrimination and to promote a "European" or "Community" outlook in economic and business policy. So it was felt desirable to develop uniform basic principles for turnover

taxes to apply throughout the Community and to replace existing taxes in this category (such as sales taxes, customs duties). The model chosen for this purpose was the French value added tax, and this form of tax was adopted throughout the EEC in 1970 (replacing numerous existing indirect taxes). The value added form of tax has become popular and has been adopted, in principle, in countries outside the EEC and outside Europe. The value added principle has also been the subject of considerable study in North America (see e.g. a report for the American Bar Association, namely, Report of the Special Subcommittee of the Committee on General Income Tax Problems on the Value-Added Tax, 24 Tax Lawyer, pp. 419-434; 26 Tax Lawyer, pp. 45-76; 28 Tax Lawyer, pp. 193-220; 29 Tax Lawyer, pp. 457-474). Studies have been initiated by the Commission of the EEC with a view to greater harmonization of the existing national V.A.T. versions throughout the E.E.C. (e.g. in regard to rates and rules for application of the tax).

The basic principles of VAT can be indicated by two simple examples:

(A) X owns a restaurant. VAT may affect the sale of meals to customers and the purchase of restaurant supplies. Under VAT, X is taxable on the proceeds of the sale of meals, but he can add the VAT to the price of the meal, and so he collects the tax from the consumer.

Suppose Y is one of X's suppliers. Y is taxable on the proceeds of sales to X, but he can add VAT to the prices when he

bills X for supplies, and so he collects the tax from X.

X's position is now that (i) he has collected VAT from his restaurant customers and (ii) VAT has been collected from him by Y and his other suppliers. So X pays to the revenue authorities VAT collected by him under (i) minus VAT collected from him under (ii). If this difference is negative X is entitled to a refund.

(B) B, who makes furniture, purchases timber from A at a price of 1250 and fittings from C at a price of 250. B sells completed furniture to a retailer at a price of 6250. The rate of VAT is 8%.

A collects from B, 8% of 1250 = 100

C collects from B, 8% of 250 = 20

B collects from the retailer, 8% of 6250 = 500

Thus B pays to the revenue authorities (500 - 120) = 380.

The revenue authorities receive (from these 3 transactions):

100 + 20 + 380 = 500. The retailer can collect VAT from his customers. A and C can set-off, against the 100 and the 20 respectively, any VAT collected from them.

V.A.T. is not borne by the taxable person: he passes the tax burden on by adding the amount of the tax to his bill. The tax process begins with the primary producer (who has had no VAT collected from him and simply pays to the revenue the whole amount he has collected) and ends with the ultimate consumer (who has no one on whom to shift forward the tax).

In some systems a supplier or manufacturer may take credit not only for the VAT paid on supplies of goods, services, capital equipment etc.

The revenue authorities receive (in all) VAT on the price paid by the ultimate consumer, but this amount is spread over the

different stages of the production process, being related to the taxable "value added" at each stage of that process. VAT may be defined as a tax payable in "value-added" instalments by a taxable individual or entity (some individuals and entities are exempt from VAT and some goods and services are zero rated for VAT) at each stage of the production process, on taxable goods and services provided by a taxable person.

Special treatment is accorded to exports and imports in relation to VAT. (There are no customs duties between EEC countries).

Consider the export/import of certain goods from the U.K. to France.

The rate of V.A.T. on exports is zero. So there is no U.K. V.A.T. on the export/import transaction.

French V.A.T. is payable by the French buyer on the imported goods. The result is similar to payment of customs duties by an importer, but in the case of VAT, the tax is fully integrated with the domestic system of (V.A.T.) turnover tax, so equalizing the treatment of domestic transactions and export-import transactions.

[See also: Report on the Value-Added Tax, 24 Tax L. 419; 26 Tax L., 45; 28 Tax L., 193; and 29 Tax L., 457. Due, Swiss Experience and the Canadian Wholesale Sales Tax Proposal, 24 Can. Tax J., 103.]

The two articles which follow are:

(i) Rhoades, U.S. Tax Aspects of Operating Abroad, 5 Denver Journal of International Law and Policy, pp. 45-75 and (ii) Bryan, Tax Implications of Japanese Multinational Corporations, 8 New York University Journal of International Law and Politics, pp. 153-209. The first article discusses international tax planning on a "problem approach" basis from the viewpoint of a U.S. parent corporation. The second article gives some insight into Japanese attitudes to multinational tax planning indicating some of the differences between business organization and thinking in Japan and in North America.

Multinational Corporations Seminar

Notes on International Tax Planning

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NOTES ON COMMON INTERNATIONAL TAX PLANNING PROBLEMS AND TECHNIQUES

1. International tax and business planning

There is no such thing as "international taxation": taxes are imposed by nations or political subdivisions, and international tax planning is concerned with the interreaction of different tax systems of different countries in their application to business or investment that involve more than one country.

The primary objectives of international tax planning are to

(i) minimize total tax burden (the aggregate burden, not the components, is important)

(ii) reduce the adverse impact of government restrictions

(iii) provide the necessary flexibility to meet changing tax and other regulations, as well as economic trends.

2. Direct exports

In dealing with the direct export of goods, taxpayers have to be aware of both the domestic and foreign taxes that may be imposed on the income. The question of whether a taxpayer will be subject to income tax in the foreign jurisdiction to which he is exporting goods will depend on just how he carries on his business in that country: frequently, exposure to foreign taxes will arise when he maintains a permanent establishment (under a definition in a tax treaty) in a jurisdiction, but tax laws in this area are far from uniform and tax treaties may not always apply to provide an even partial codification of the rules. If there is a liability for taxation abroad, the taxpayer must consider whether he has a foreign tax credit available under the domestic law: this in turn will give rise to questions of the source of the income from the sale of the exported goods under domestic rules, and the quantity of foreign source income: the amount of foreign source income

under the domestic rules may differ from the amount taxed abroad, and this and other problems can lead to difficulties in obtaining a full foreign tax credit domestically for the foreign taxes, leading to "double taxation".

The taxpayer may also be involved with considerations as to the fair value of the goods exported, for the purpose of calculating his tax liability in the foreign jurisdiction.

The taxpayer will also have to be concerned with the availability of export incentives in the domestic jurisdiction, and customs and other barriers and costs in the foreign jurisdictions.

3. Licensing unrelated parties abroad

Taxpayer may decide to earn revenue through licensing unrelated parties in foreign jurisdictions: he will obviously be concerned with the various types of licensing arrangements, and the remuneration therefor, with their varying business and tax implications. Amongst the issues to be considered are the following:

- computation of royalties and revenues: difference if any in domestic tax treatment between lump sum and re-occuring payments
- deductibility of royalty by payer under foreign tax rules
- imposition of foreign withholding and other taxes abroad
- availability of foreign tax credits domestically for foreign taxes: will entire royalty be considered as foreign source income if expenses to earn it are incurred domestically?

4. Leasing

The taxpayer may decide to lease equipment to customers in foreign jurisdictions: the taxpayer will have to consider the tax position of his customers abroad, under the foreign tax law, as well

as a number of tax and non-tax advantages and disadvantages of engaging in leasing activities. Amongst the issues to be considered may be the following:

- taxation of lease income abroad: taxes based on gross or net income? If net, what depreciation, investment tax credits, etc., available?
- taxation domestically (source of leasing income, availability of tax credits, etc.), and calculation of net foreign income under domestic rules.

5. Foreign branch vs. subsidiary

When the taxpayer's activities abroad are clearly sufficient to constitute a separate "branch", the profits of which will be subject to tax abroad, the taxpayer will have to carefully consider whether it is appropriate to carry on the foreign operations through a branch of the domestic company, or through a newly incorporated subsidiary (presumably but not necessarily incorporated in the foreign jurisdiction).

In analyzing the situation, the taxpayer will have to consider a number of non-tax factors: these can include restrictions that may be imposed abroad on foreign ownership of corporations; rules relating to the minimum capitalization of corporations and reporting requirements; the level of charges for the incorporation of companies and annual filing and other costs; the desirability of achieving limited liability with respect to foreign operations through use of a subsidiary; the possible advantages of a subsidiary with respect to relations with local customers; possible access to local incentives etc. through using a local subsidiary; and so forth.

Amongst the tax factors to be considered will be the following:

- the taxpayer's position in his home country: as long as the operation is run as a branch, there will be immediate taxation of foreign branch profits (except where he is located in a country with "territorial" tax concept) and correspondingly there may be an immediate deductibility of foreign branch losses (a possible significant consideration in startup years.)

  The taxpayer will also wish to consider the availability of a subsequent tax-free rollover of branch assets into a subsidiary, under both domestic and foreign tax rules, if he contemplates initial operations through a branch.

- Tax considerations in the foreign jurisdiction: the maintenance of a permanent establishment under a force of attraction doctrine may create new tax liabilities unconnected with the branch; there may be a possible "branch tax" imposed on branch profits designed to be the equivalent of a withholding tax on dividends; there may be additional uncertainties with respect to the determination of transfer prices and separate branch profits under a branch operation as well as additional problems on the deductibility by the branch of payments credited to a head office account on account of interest or royalties; the application of withholding tax on dividends from a subsidiary, and the credits available domestically for such taxes as well as the application of withholding tax on dividends from a subsidiary, and the credits available domestically for such taxes as well as the application of domestic tax rules to dividend income from a foreign subsidiary as opposed to profits from a foreign branch.

6. Tax treaties

The purpose of bilateral international tax treaties is to alleviate double taxation, prevent evasion, and reconcile differences in tax systems which may hinder trade or investment.

- over 1,000 tax treaties now in existence, including income tax treaties, death tax treaties, treaties limited to international

transportation, etc.

- income tax treaties are frequently modelled on OECD model treaty, but developing countries have major objections to OECD approach, and all countries have different policies and approaches in at least some areas

- treaty articles concern such issues as use of "permanent establishment" as a basis for taxing business and commercial profits: limitation of taxes imposed on remittances of dividends, royalties, interest, etc.: competent authority provisions for reconciliation of direct conflicts over source of income; exchange of information, etc.

- drafting and interpretation of treaties is difficult because of different concepts, approaches in the two countries.

7. Tax Havens

Tax havens can be divided into those jurisdictions which impose no taxes on income at all, those that impose minimal taxes, those which generally tax domestic source income but not certain income from foreign sources ("territorial concept"), those which have favourable tax treaties which reduce foreign taxes on income flowing to them, and those which, because of special features of domestic law, may be useful for certain purposes.

Selection of tax haven may depend on factors such as:

- political and economic status (stability)
- taxes and fees
- transport, communication, banking and professional services
- exchange controls
- availability of international tax treaties
- legal system

Finding a tax haven with a relatively low tax on at least specified types of income is usually not a difficult task: the real test is whether the income in question can be properly earned and received by the tax haven subsidiary. In this regard, reference would likely have to be made to both the domestic tax rules of the investor and the rules of any foreign jurisdiction where the income might originate.

8. Anti-avoidance rules

The use of tax strategies to reduce taxation on inter-company income flows must consider anti-avoidance legislation, enacted by both the host and foreign countries, designed to prevent tax abuses through the use of tax havens, the receipt of "passive" income in tax havens and the diversion of business and other profits to low tax jurisdictions through artificial pricing arrangements, etc.

The tax rules that may be applicable to prevent such diversion include:

- "arm's length" pricing and other rules on intercompany transactions
- exchange of information between governments under tax treaties
- specific anti-avoidance provisions (Canada-FAPI, U.S.- sub part F)

9. Foreign holding companies

Taxpayers can find that advantageous use may be made of holding or investment companies incorporated in foreign jurisdictions to hold other investments abroad, i.e., as for example where a Canadian corporation, instead of owning a U.S. subsidiary directly, will have such a subsidiary owned by a Netherlands holding company which is itself a subsidiary of the Canadian taxpayer.

The use of such foreign holding companies can have a number of advantages:

- it may avoid foreign exchange controls or reduce exchange risks

- it may defer remittance of dividends or other profits (including capital gains) to home country, and this may defer incidence of domestic taxation

- it can reduce withholding taxes on dividends, interest and other international income flows, through having investment company take advantage of tax treaties of its host country

- it can enable advantageous "merging" of foreign tax credits through "mixing" income streams

The use of foreign holding companies is of particular importance to Canada because of the high withholding taxes provided in Canada's treaties, which provide an incentive to use holding companies in countries with a better treaty system (Netherlands).

10. International finance subsidiaries

The establishment of an international financing subsidiary, possibly in a tax haven, can have a number of tax and non-tax advantages. Before establishing such a subsidiary, it is necessary to consider related issues, such as the reliance on internal vs. external financing, and the appropriate debt to equity ratio in the financing of foreign subsidiaries.

It may be possible to establish a foreign financing subsidiary which in turn can lend funds to other foreign subsidiaries abroad, with the interest on such loans being deductible by the paying subsidiaries in the calculation of their income, but only subject to relatively modest tax liability (including withholding taxes) by the financing subsidiary. Attention will have to be paid to the deductibility of such interest charges abroad including foreign "thin capitalization" rules.

When interest expense in incurred in a holding company, perhaps to finance a share acquisition, consideration must be given to the possible utilization of the deduction of such interest (as in a consolidated return).

11. Holding companies for patents and intangibles

The usual purpose of forming a foreign patent etc. holding company abroad is to enable income to be earned in a "low tax" jurisdiction, considering both local taxation and withholding taxes:

- the arrangement may defer domestic taxation of royalties

- if appropriate, use can be made of "back to back" licensing arrangements (i.e., Luxembourg company licensing Dutch company, etc.) to minimize foreign tax

- tax problems may be encountered in the transfer of the patents technology, etc. to the foreign company, and the servicing of clients

12. Foreign sales subsidiaries

Basic objective is to establish an international trading subsidiary in a low tax jurisdiction, so that "trans-shipment profits" can be subject to low rates of tax. The trading subsidiary, perhaps located in a tax haven, will purchase goods and then resell than at a profit. The issues to be considered include:

- danger of attack from interested jurisdictions (sham, artificial pricing, diversion of income)

- the necessity of supporting documentation

- the use of a re-invoicing or commission approach

- location of sales subsidiary (Switzerland, Panama, etc.)

13. Management companies

The taxpayer may consider the possible use of a management facilities company for all or part of an international group, charging out expenses (perhaps at a mark up) to other affiliates; issues to be considered include:

- local tax considerations relative to location

- location and personal tax position of relevant executives

- deductibility of payments to management company by other affiliates, and withholding taxes thereon

- possible use of U.K., Monaco, Switzerland, etc.

14. Joint ventures

Joint ventures, frequently with a local enterprise,

- tax or other advantages in having local partner

- use of partnership to flow through income, deductions, losses, to a particular entity in group

- use of a foreign corporation as taxpayer's participant in venture results essentially in a foreign branch situation

- overall tax flexibilty may be maximized

15. Research and development

Allocation of Research and Development expenses in an international corporate group may be facilitated by specific R & D arrangements, including R & D joint ventures, a separate R & D subsidiary, basic cost sharing and benefit sharing approaches, etc. Tax considerations in home country (source of income, adequacy of charges, tax credits) and abroad (deductibility, withholding and other taxes etc.) must be considered.

16. Intercompany pricing

Taxpayers in international businesses will have a natural temptation to attempt to shift income to entities and jurisdictions where it will be taxed at relatively low rates, away from "high tax" countries. On the other hand, governments, acting individually, may seek to disturb existing pricing arrangements so as to gain the maximum amount of taxable income for their own jurisdiction: it is quite possible for governments concerned with an international transaction to collectively attempt to tax far more than 100% of the net income on the entire activity, as there is no uniform approach to fair value determinations.

Intercompany pricing issues arise not only with respect to the prices charged for goods, but also with respect to charges between affiliated companies in respect of interest, royalties, management fees, loan guarantee fees, support and technical services, insurance premiums, etc. The level and nature of such charges may have non-tax implications, as for example with respect to customs duties, exchange controls, minority shareholders, and the calculation of employee profit sharing bonuses.

17. Foreign exchange controls

Foreign exchange controls and related exchange risks may be of such importance that they may over-ride all other considerations relating to where profits should desirably be earned.

18. Captive insurance companies

The use of a captive insurance company, likely located in a tax haven jurisdiction, can have both tax and non-tax advantages. Such a captive insurance company will typically insure risks of related companies in their various operations, and then may reinsure all or part of such risks on a reinsurance basis. In effect, the use of such a captive insurance company can be a means of obtaining substantial blocks of insurance wholesale, rather than retail prices, providing the company is willing to "service" its own risks (or hire such services from others). If all risks are not reinsured with outside parties, then the enterprise on a

consolidated basis is acting as a self-insurer, and presumably hopes to accumulate a pool of funds abroad to help "cover" such risks.

If the offshore insurance subsidiary is located in a tax haven, it may offer the opportunity to earn insurance and investment income on a tax free basis.

The establishment of such a subsidiary will require an analysis of the deductibility of premiums in various jurisdictions, the application of local rules relating to foreign insurers (premium taxes, etc.) and other tax considerations, including a possible imposition in Canada of the FAPI rules.

Possible locations for such an offshore insurance vehicle include Bermuda and the Channel Islands.

19. International shipping and other transportation

The taxpayer can consider the establishment, likely in a tax haven, of an international shipping or other transportation company which may own or lease ships, containers, etc.: normally the expectation is the earning of transportation profits in an offshore, low tax jurisdiction. The issues to be considered include the following:

- source of income: the possible taxation of such income by local jursidictions

- implications of double tax treaties

- use of tax havens (Liberia and Panama) for ships, etc.

- possible risk of major losses

20. Foreign exchange gains and losses

In arranging for international investment in loans, the taxpayer must consider the treatment of gains and losses arising from foreign exchange operations both domestically and in all affected jurisdictions:

- tax treatment differs from country to country: planning may try to put gains and losses in appropriate jurisdiction where most favourable tax treatment may apply or to avoid having major losses in countries where such losses may not be deductible

- possible side implications (i.e., loss of qualification of Dutch holding company under Canada-Netherlands tax treaty, possible application of FAPI rules)

21. International monetary management

The taxpayer involved in a major international business may consider the centralization of monetary management, both for cash flow and minimization of foreign exchange risks, into one central corporate entity which will undertake to act as an intermediary with all corporations in international group, dealing with each in its own currency.

22. Foreign investment incentives

A taxpayer concerned with international operations will wish to consider general and specific issues relating to business and other incentives available abroad:

- general incentive policies (EEC, GATT): will incentives be subject to countervailing duties, or be "taxed away" on remittance of profits subject to local incentives?

- particular incentives (Puerto Rico, Ireland, Italy, Canada, U.S., etc.)

23. Business entities

The variation in the form and legal and tax implications of various entities (Liechtenstein Anstalt, South Amercian "company" etc.) may require careful consideration because of both tax and general legal implications

24. Differences in tax systems

Taxpayers have to consider the implications of different tax systems and approaches used in various countries. One of the major issues at the moment is the basic conflict between two systems of corporate taxation:

- classical (unintegrated) system, with corporate tax plus personal tax at shareholder level, as in U.S.A.

- integrated tax systems, with tax credits to shareholders for corporate tax: German, French, U.K. systems (partial "pure" integration) may be distinguished from Canadian, Italian systems (modified integration). The EEC is moving towards the general use of an integrated, harmonized tax system)

Integrated tax systems can tend to discriminate against foreign investment, unless tax treaties flow through integration credits (U.K. Treaty with Netherlands, French Treaty with U.S.).

25. Protection of assets

It is possible to attempt to provide "failsafe" protection against some foreign expropriation risks with "snap back" agreements under trust arrangements, and other approaches.

26. Expatriation of corporations

The issue of "transnational" mergers or even incorporation is receiving attention in Europe and elsewhere: international business reorganizations and mergers can be extremely complex because of tax and legal problems

27. Employee compensation abroad

An international enterprise must pay particular attention to tax position of its employees, especially expatriates:

- compensation methods, approaches and levels may vary
- difference between home country and foreign service country levels of tax can create problems.
- taxation of U.S. citizens on world income is a major complication
- treatment of fringe benefits can be a concern, or a tax saving opportunity
- many companies have "equalization" plans, to maintain employees' after-tax income at predetermined level: "excess" foreign taxes may then be employer's expense
- balloon payments before or after foreign tour of service can achieve tax savings

28. Value added tax and other consumption taxes

The application of VAT and other taxes can influence method of organization

29. International attitude towards multinational entities

International enterprises must be sensitive to development such as:

- possible trends in attitudes towards multi-nationals
- rising concern over use of tax havens, "advanced" international tax planning, pricing issues, treaty shopping, etc.

- efforts at international cooperation amongst taxing jurisdictions (EEC, joint Canada-U.S. audits, etc.)

** ** **

September, 1979

STATUS OF CANADA'S TAX TREATIES

(At August 31, 1979)

		New Treaty		
	A Treaty in Force	Signed, not yet ratified	Awaiting Signature	Under Negotiation
Argentina			X	
Australia	X		X	
Austria		X		
Bangladesh			X	
Barbados			X	
Belgium	X			
Brazil			X	
Cyprus			X	
Denmark	X		X	
Dominican Republic	X			
Egypt			X	
Finland	X		X	
France	X			
Federal Republic of Germany	X			X
Grenada				X
India				X
Indonesia		X		
Ireland	X		X	
Israel	X			
Italy		X		
Ivory Coast				X
Jamaica	X	X		
Japan	X			X
Kenya			X	
Republic of Korea		X		
Liberia		X		
Malaysia		X		
Mexico				X
Morocco	X			
Netherlands	X			X
Netherlands Antilles				X
New Zealand	X		X	
Nigeria				X
Norway	X		X	
Pakistan	X			
Philippines	X			
Portugal			X	
Romania		X		
Senegal			X	
Singapore	X			
South Africa	X			
Spain		X		
Sri Lanka			X	
Sweden	X		X	
Switzerland	X			
Thailand				X
Trinidad & Tobago	X			X
Tunisia			X	
Union of Soviet Socialist Republic				X
United Kingdom	X	X		
United States	X			X
Windward & Leeward Islands Antigua, Belize, Dominica Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia, St. Vincent			X	
Yugoslavia				X
Zambia			X	

SCHEDULE OF NON-RESIDENT TAX RATES FOR TREATY COUNTRIES

COUNTRY	Effective Date	Management Fees	Interest		Interest Other (NOTE A)	Estate or Trust Income	Rentals	Rentals Other (NOTE B)	Royalties		Royalties Other Incl. Timber Royalties (NOTE C)	Alimony	Dividends Including Patronage Dividends (NOTE D)		Films		Pensions and Annuities		Pensions Out of Public Funds	Lump Sum Out of Pensions Annuities or Similar Payments
		Rate	Art.	Rate	Rate	Rate	Rate	Rate	Art.	Rate	Rate	Rate	Art.	Rate	Art.	Rate	Art.	Rate	Rate	Rate
AUSTRALIA		25		25	15	25	25	25		25	25	25		15		25		Nil	Nil	25••
BELGIUM	JAN. 1/76	25		15	–	15	10	25		10	25	Nil/25•		15		10		25	25	25
DENMARK		25		15	15	25	15	15		15	15	25		15		15		Nil	Nil	25••
DOMINICAN REPUBLIC	JAN. 1/77	25		18/25•	–	18/25•	18/25•	25		18/25•	25	Nil/25•		18		18/25•	XVIII(3)	18 25	18	25
FINLAND		25		15	15	25	15	15		15	15	25		15		15		Nil	Nil	25
FRANCE	JAN. 1/76	25		15/25•	15	15/25•	10/25•	25	XII(3)(b)	10/25• Nil	25	Nil/25•		15	XII(4)	10/25• Nil/25•		25	25	25
GERMANY (WEST)		25	XIII	15 25	15	25	25	25		15	25	25	VI(1)	25 15		10		Nil	25	25
IRELAND		15		15	15	15	15	15		15	15	15	VII(2)	15 Nil		15		Nil	Nil	15
ISRAEL	APRIL 1/76	25		15/25•	–	15/25•	15/25•	25		15/25•	25	Nil/25•		15		15/25•	XVIII(2)	15 25	15	25
JAMAICA		25		25	15	25	25	25		25	25	25		22.5		25		25	25	25
JAPAN		25		15	15	25	15	25		15	25	25		15		15		25	25	25
MOROCCO	JAN. 1/78	25		15/25•	–	25	10/25•	25		10/25•	25	25		15		10/25•		25	25	25
NETHERLANDS		Nil	III	15 25	15	25	15	25		15	25	Nil	VII(3)	15 Nil		15		Nil	Nil	Nil
NEW ZEALAND		25		25	15	25	25	25		25	25	25		25		25		Nil/25•	Nil/25•	25••
NORWAY		25		15	15	15	25	25		15	25	Nil		15		10		Nil	Nil	25
PAKISTAN	JAN. 1/77	25		15/25•	–	15/25•	15/25•	25		15/25•	25	15/25•		15		15/25•		25	25	25
PHILIPPINES	JAN. 1/77	25		15/25•	–	25	10/25•	25		10/25•	25	25		15		10/25•		•••	•••	25
SINGAPORE	JAN. 1/77	25		15/25•	–	15/25•	15/25•	25		15/25•	25	15/25•		15		15/25•		25	25	25
SOUTH AFRICA		25		25	15	25	25	25		25	25	25		25		25		25	25	25
SWEDEN		25		15	15	25	15	15		15	15	25		15		15		Nil	Nil	25••
SWITZERLAND	JAN. 1/76	25		15	–	15	10	25		10	25	Nil/25•		15		10		15 25	15	25
TRINIDAD & TOBAGO		25		15	15	25	15	25		15	25	25		15		15	XVIII(1)	Nil	Nil	25••
UNITED KINGDOM		25		15	15	25	10	25		10	25	Nil		15		10		Nil	Nil	25••
UNITED STATES		15		15	15	15	15	15		15	15	15		15		15		Nil	Nil	15

•The lesser rates apply only where the income payment is taxeble in the country of residence of the beneficiel owner, otherwise the rete is generally 25%.

••A Nil rate of withholding applies to lump sum payments out of Pension Plans Only.

••• Periodic Pension Payments to $5000 – Nil
Periodic Pension Payments Excess over $5000 up to $30,000 – 30
Periodic Pension Payments over $30,000 – 25
Periodic Annuities – 25

NOTES

(A) INTEREST - OTHER - Subsection 10(4) of the Income Tax Application Rules, 1971 (ITAR, 1971)

Where an amount is paid or credited by e person resident in Canada to e non-resident person,

(a) who is resident in e prescribed country, and
(b) with whom the person resident in Canada was dealing et arm's-length,

as, on account or in lieu of peyment of, or in satisfaction of, interest peyable on any bond, debenture, mortgage, hypothec, note or similer obligation issued before 1976 by the person resident in Canada to the non-resident person, for the purposes of computing the tex under Part XIII of the amended Act payable by the non-resident person on the emount, subsection 212(1) thereof shall be read as if the reference therein to "25%" were read as a reference to "15%".

(B) RENTALS - OTHER - refers to peyments made for the use of or the right to use reel or immoveble property including natural resources in Canada.

(C) ROYALTIES - OTHER - refers to peyments made for the use of or the right to use real or immovable property including natural resources in Canada.

(D) For Corporations which quelify for e degree of Canadian Ownership, the rate specified in the schedule will have to be further reduced by 5 percentage points in accordance with subsection 212(3) of the Income Tex Act.

- No withholding on e royalty or similer payment on or in respect of e copyright in respect of the production or reproduction of eny literary, dramatic, musical or ertistic work, (Subparagraph 212(1)(d)(VI) of the Income Tax Act).
- Where two or more rates are noted clerification mey be obtained from the relevent Articles of the Tax Conventions or Agreements.
- For all non-treety countries the rate is 25% generally.
- Effective dates have been indicated only for new and renegotiated Tax Agreements.

SUMMARY OF CANADIAN TAXATION OF FOREIGN SOURCE INCOME

1. EMPLOYMENT AND PORTFOLIO INVESTMENT-TYPE INCOME

- included in taxable income of a Canadian resident, as calculated on a Canadian tax
- credit given for direct foreign income taxes ("non-business income tax") imposed thereon:

  - Foreign tax credit allowed under S.126(1): Credit is in general lesser of:

    - Foreign tax (non-business), and

    - Foreign non-business income from country
      ——————————————————— X CANADIAN TAX*
      Total income (less exempt dividends, etc.)

      * after provincial abatement

    - Elective deduction in determining income is available for all taxpayers in respect of foreign non-business income tax: tax deducted is not creditable (S.20(12))

  - Foreign tax that is creditable on non-real estate property income of individuals is, for 1976 and thereafter, limited to 15% of gross income (S.20.11): tax which is not creditable is deductible.

  - Calculations required on separate basis for each country with no carryover

  - Limited credit may be available against provincial income tax for "excess" foreign taxes (over amount creditable against federal tax)

2. BRANCH AND OTHER FOREIGN BUSINESS INCOME

Income is taxed with credit given for foreign income taxes (business income tax) imposed thereon (S.126(2))

- credit is lesser of:
  - foreign business tax, and
  - $\frac{\text{foreign business income from country}}{\text{total income (less exempt dividends, etc.)}} \times \text{CANADIAN TAX*}$

    * before provincial tax abatement

- five year carryover of excess foreign taxes allowed
- calculations required country-by-country basis
- taxes "in lieu of" income taxes may be creditable (S.126(5))

3. DIVIDENDS FROM FOREIGN AFFILIATES

Foreign affiliate definition:

A corporation resident outside of Canada in which a Canadian resident owns ten percent or more of any class of its issued stock, directly or through other foreign affiliates (95(1)(d)). The technical definition is a non-resident corporation in which a taxpayer (other than an NRO) owns a 10% "equity interest" or more: equity interest is the highest percentage of any class of shares of the affiliate "owned" by the shareholder, considering both direct and indirect interests through foreign or Canadian corporations. (95(4)(a) and (b)).

Example: Canco Ltd. owns 60% of the preferred shares of Dutchco N.V. Dutchco owns 30% of the preferred and 40% of the commmon shares of Frenchco S.A. Dutchco is a foreign affiliate of Canco, with direct equity percentage of 60%: Frenchco is a foreign affiliate of Canco, with an indirect equity percentage of 24% (60% x 40%).

Source (character) of dividends:

Dividends received by individuals are treated as portfolio dividends taxed but with tax credit only for direct withholding, etc., taxes.

A Canadian corporation receiving dividends from a foreign affiliate must determine which surplus account the dividends are paid out of -

- exempt surplus
- taxable surplus
- pre-acquisition surplus
- Dividends paid out of exempt surplus are not included in the taxable income of the Canadian corporation (113(1)(a))
- Dividends paid out of taxable surplus are taxable, but relief is afforded through the equivalent of a foreign tax credit for underlying corporate income tax as well as withholding taxes applicable thereto. (S.113(1)(b), (c) - see below for example)
- Dividends paid out of pre-acquisition surplus are not included in income but reduce the adjusted cost base of the shares. (S.113(1)(d), 92(2).)
- Dividends that are excluded from taxable income from a non-controlled foreign affiliate can be subject to Part IV tax to a private company.

Exempt surplus - basically active business income (after tax) derived by a treaty foreign affiliate in a treaty country (plus all active business income arising in 1972-75, and all capital gains that do not get into FAPI). Exempt surplus pot is really excess of exempt surplus over taxable deficit (R5901, 5907). Note - "Treaty" and "non-treaty" really mean countries listed or not listed in (R.5(11). All dividends received to end of 75 are deemed to come out of exempt surplus. (S.113(4).)

Taxable surplus - basically active business income (after tax) earned in a "non-treaty" country after 1975, plus FAPI: taxable surplus pot really represents excess of taxable surplus over exempt deficit: it carries with it an underlying tax account representing foreign income taxes paid such earnings: (R.5907, 5901).

Pre-acquisition surplus - a residual, (representing ACB of shares of foreign affiliate, to extent that it can be assigned a value)

Earnings - It is the earnings of a foreign affiliate that are used to build up exempt and taxable surplus: these earnings are computed on a foreign tax basis if subject to foreign tax (but adjusting all inclusions and deductions to a 100% basis) and on a Canadian tax basis otherwise (R.5907): generally added in only at the end of fiscal year.

Under 1978 amendments, exempt earnings of a foreign affiliate can be calculated, by election, using book depreciation instead of tax depreciation: this can have the effect of greatly increasing available exempt earnings to "cover" dividends (R.5907(2.1)).

The "surplus pots" are defined by reference to each particular Canadian corporate shareholder.

Dividends paid in first ninety days are deemed to come out of exempt, taxable, and pre-acquisition surpluses in that order (R.5901(1)).

Dividends paid after ninety days come out of (in order)

- exempt surplus at previous year end
- taxable surplus at previous year end
- increase in exempt and then taxable surplus during year
- pre-acquisition surplus
- the foregoing does not apply for Section 93 elections (R.5901(2)) discussed below

Inter-affiliate dividends flow from one affiliate to another, retaining some surplus pot identity: are accounted for currently.

Basic relief - deductions from income for foreign tax

Relief is only required in respect of dividends out of (or deemed to be out of) taxable surplus since dividends from the other "surplus pots" are not included in income. This relief is granted by way of deduction rather than credit for foreign tax. The underlying foreign tax times (the relevant tax factor - 1) (S.113(1)(b)) and the foreign withholding tax times the relevant tax factor (S.113(1)(c)) are the amounts of the deductions available - but limited to the amount of the dividend.

Example:

Foreign income (taxable surplus)	100
Foreign corporate tax	20
	80
Foreign withholding taxes	8
Net cash dividend to Canada	72
Canadian corporation includes in income	80
Deductions:	
(a) for foreign tax applicable 20 x (2.174* - 1) =	(23)
(b) for foreign withholding tax 8 x 2.174* =	(17)
Net income	40
Canadian tax at 46%	18
Foreign tax (20 + 8)	28
Total taxes	46

* relevant tax factor as discussed below

Relevant tax factor is a concept used in computing the appropriate deduction allowed in computing income in respect of foreign taxes.

The relevant tax factor is, for an individual, 2, and for a corporation, is the reciprocal of the basic federal rate of corporate tax (i.e., for 1979 - 1/46% = 2.1739 (95(1)(f))

The relevant tax factor is used to give the appropriate result in respect of the deduction of foreign taxes, i.e., equivalent to the result that would obtain under a foreign tax credit approach. For underlying tax (corporate tax on income out of which dividends are paid), the deduction is the tax x (relevant tax factor - 1) since tax has already been deducted in computing net income available for dividends.

Simplified example:

	Foreign tax credit approach	Actual Legislation
Income of foreign subsidiary (included in taxable surplus)	100	100
Foreign corporate tax thereon	20	20
After tax income paid as dividend to Canadian company	80	80
Canadian company includes in income	100	80
Deduction approach -		
claims deduction of 1.1739 x $20	—	23
	100	57
Tax at 46%	46	26
Less - foreign tax credit	20	—
Net Canadian tax	26	26
Total taxes	46	46

The underlying foreign tax applicable to a dividend out of taxable surplus is a proportion of the foreign income taxes imposed on the active business income flowing into the taxable surplus of a foreign affiliate. It is normally applied and reduced pro rata as dividends are deemed to flow out of taxable surplus of the foreign affiliate. (R.5907(1)(m), (n).)

Elective and special relief provisions

- Disproportionate allocation of underlying tax (provided only if one class of share outstanding) (R.5907(1)): taxpayer can apply any elected amount of foreign tax into available foreign underlying tax to "cover" a dividend out of taxable surplus.

- Exclusion of dividend from taxable surplus from income and application to reduce ACB of shares (provided shares owned at end of 1975) (S.113(2)))

- Tax sparing relief (provided investment made before 1976) (R.5907(10)) - dividends out of earnings subject to foreign incentive legislation may be exempt even if non-treaty country

- Calculation of "earnings" of a foreign affiliate in a listed country can be made on the basis of book depreciation, not tax depreciation if so elected (R.5907(2.1)).

The above special reliefs can be of extreme importance in avoiding or postponing tax on foreign dividends. The last noted item above, added in 1978, is effective for 1978 and subsequent taxation years: it can be very useful in ensuring that dividends paid by a subsidiary are "covered" by its earnings and hence do not reduce the adjusted cost base of the shares.

NOTE: A reorganization or shift of ownership of shares of foreign affiliate can result in loss of certain of these reliefs.

4. FOREIGN ACCRUAL PROPERTY INCOME (FAPI)

FAPI of a controlled foreign affiliate of a Canadian resident taxpayer is attributed back to the Canadian shareholder and is taxed currently in his hands. Only the FAPI of controlled foreign affiliates is taxed currently. For this purpose the foreign affiliate can be controlled directly or indirectly in any manner whatsoever by the taxpayer alone, or with not more than four other Canadian residents, or by any related group of which the taxpayer was a member. (S.95(1)(a).)

Determination of FAPI

FAPI is basically the income of a foreign affiliate from property, businesses other than active business, and taxable capital gains. (95(1)(b).)

FAPI includes:

- amounts earned by the foreign affiliate from services if

    - the amount is deductible in computing the income of a business carried on in Canada by any person to whom the foreign affiliate is a controlled foreign affiliate, or any related party: services for this purpose include the insurance of Canadian risks, but does not include transport, import or export services, or

    - The services are to be performed (anywhere) by a person (or a related party) to whom the affiliate is a controlled foreign affiliate. (95(2),(3)).

FAPI does not include:

- a dividend from another foreign affiliate (or a dividend from a Canadian corporation and certain interest on foreign debt received on sale of foreign assets and guaranteed by a foreign government)

- income that "pertains to or is incident to" an active business carried on by a foreign affiliate or any non-arm's length non-resident corporation

- any amount received from another foreign affiliate (or any other non-arm's length non-resident corporation) to the extent deductible by that company in computing its income from an active business outside of Canada (95(2)(a)).

  Example -

  Interest earned by a Bermuda affiliate on a loan to a French affiliate for use in the French company's active business is not FAPI.

- under proposals in November 1978 Budget, gains or losses due to foreign currency fluctuations on loans between affiliates would not be included in FAPI

- appreciation in the value of capital assets which had occurred before the beginning of the affiliate's 1976 taxation year, or capital gains or losses accrued before foreign corporation became foreign affiliate (95)(2)(f)).

- capital gains on assets used principally for the purpose of earning income from active business.

- capital gains (or losses) on settlement of debt between foreign affiliates

FAPI can be reduced by:

FAPI losses of the same affiliate

allowable capital losses of affiliate (or non-active business property)

a five year carryover of FAPI losses, etc. (R.5903)

certain deductions for foreign taxes, with a five year carryover (S.91(4), (95)(1)(c))

Current taxation:

A Canadian taxpayer includes in his income his "participating percentage" of the FAPI of controlled foreign affiliates for 1976 and subsequent tax years of foreign affiliates: amount is allocated at year end of affiliate.

The net amount of FAPI included in a Canadian taxpayer's income net of deductions for foreign tax discussed below) is added to ACB of shares of foreign affiliate. (When income actually received by way of dividend it reduces ACB.) (S.91,92.)

Where only common shares of the foreign affiliate used, the participating percentage is the percentage of common shares owned by taxpayer: otherwise, amount is determined by regulation. (R.5904) If FAPI less than $5,000, percentage is zero.

Tax relief for FAPI income -

FAPI is reduced by deductions in respect of withholding tax ("non-business income tax") and underlying foreign corporate income tax ("foreign accrual tax") paid in respect of FAPI, multiplied by "relevant tax factor" (individuals - 2, corporations, reciprocal of Canadian tax rate), with provision for a five year carryover of unused foreign tax deductions (91(4)).

Foreign accrual tax (95(1)(c)) is the term given to foreign taxes applicable to FAPI: the deduction allowed to a Canadian taxpayer is best illustrated by example:

Foreign FAPI	100	
Foreign taxes (current)	30	
Included in Canadian taxable income		100
Less: foreign tax x relevant tax factor (say 2*)		60
Net taxable income		40

The Canadian tax on $40 at a 50% rate will be $20 bringing total tax to 50%, the effective Canadian rate.

* Assumes 50% corporate tax rate, reciprocal of which is 2.

5. RECEIPT OF PREVIOUSLY TAXED FAPI

Since FAPI falls into taxable surplus, special rules are required to ensure that FAPI already taxed in a Canadian resident shareholder's hands is not taxed a second time when distributed to the shareholder by dividend out of taxable surplus. This is accomplished by permitting the Canadian shareholder a deduction additional to those discussed under (3) above in respect of foreign taxes. The additional deduction is equal to the portion of a dividend received representing previously taxed FAPI. (For this purpose, "FAPI" is included in taxable surplus and may be regarded as the first part of taxable surplus to be withdrawn.) As is demonstrated in Appendix B these dividends will often result in an overall reduction of Canadian tax in the year received, if foreign tax has been withheld from the dividend and the FAPI was not initially taxed at 46% or more in the foreign affiliate.

6. OTHER SPECIAL RULES

. Special rollovers available on some transfers of foreign affiliate

- shares of foreign affiliate from Canadian company to foreign affiliate (S.85.1(3))

- shares of foreign affiliate to Canadian company on liquidation of another affiliate (S.88(3))

- transfer of shares of foreign affiliate from one affiliate to another (S.95(2)(c))

- merger of foreign affiliates (S.95(2)(d) and 87(8))

- liquidation of foreign affiliate and consequent transfer of shares of an affiliate to another affiliate (S.95(2)(e))

- transfer from one Canadian company to another - domestic rollover rules apply

. other special rules -

- election on sale of shares of foreign affiliate, to deem portion of gain to be a dividend, with appropriate "levitation" of surpluses of underlying subsidiaries (S.93(1)), (R.5902)

- Restrictions on loss on sale of foreign affiliate (S.93(2))

- Election to treat dividend out of exempt surplus as taxable (R.5900(2))

- Adjustment to surplus balances on purchase or sale of partial interest in affiliate (R.5905)

. rules on sale of foreign affiliate -

- If capital gain results, any portion of gain desired may be elected to be treated as a dividend instead of a capital gain: for the purpose of determining the Canadian tax consequences of the dividend, the surplus of the foreign affiliate is deemed to "levitated". (93(1), (R.5902)

- If a capital loss results, loss will be disallowed to extent of "exempt" dividends received from affiliate. (93)(2))

- A further section disallows any loss (and gives an ACB adjustment) on the sale of shares of a foreign affiliate to a foreign affiliate (93(4)).

foreign trusts -

Modified FAPI rules apply to certain non-resident trusts and their Canadian beneficiaries.

The rules do not apply where:

- inter vivos trust created before 1960 by non-resident
- testamentary trust arising on a death before 1976

The rules only apply where a Canadian resident (or corporation or trust which does not deal at arm's length with Canadian resident) was "beneficially interested in trust".

The rules apply where trust (or foreign corporation "controlled" by trust) has acquired property directly or indirectly in any manner from a "contributor" being the Canadian beneficiary or a person who was related - including uncle, nephew, etc., to the beneficiary and such contributor had been resident in Canada for more than sixty months at any time, and was resident in Canada at any time in the eighteen month period before end of year in which contribution was made. Alternatively, rules also apply where contributor was any trust or corporation not dealing at arm's length with a contributor meeting the above qualifications.

Where rules are applicable, then, if trust contains no discretion, each beneficiary is taxed on his "share" of FAPI of trust, determined on basis of relative value of his interest in trust.

If trust contains discretion, then foreign trust is taxable as a resident of Canada in respect of its FAPI, and all Canadian beneficiaries are liable to pay such taxes to full extent of any amounts received out of trust. (Income payable to beneficiaries can deducted in determining FAPI.) (94)

7. GENERAL PLANNING COMMENTS

- Standard thoughts

  . intercompany charges to reduce foreign taxes are still acceptable: so offshore financing, licensing, etc., can still be useful: income will not be exempt surplus unless both charged against treaty country business income and received by treaty affiliate

  . use of offshore holding companies to "mix and match" surplus flows

  . Maximizing use of elections

  . Exempt surplus - how can it be maximized?

  . Bookkeeping: how to cope?

  . Attitude of Canadian authorities: need for rulings?

TORONTO, Ontario.

August, 1979